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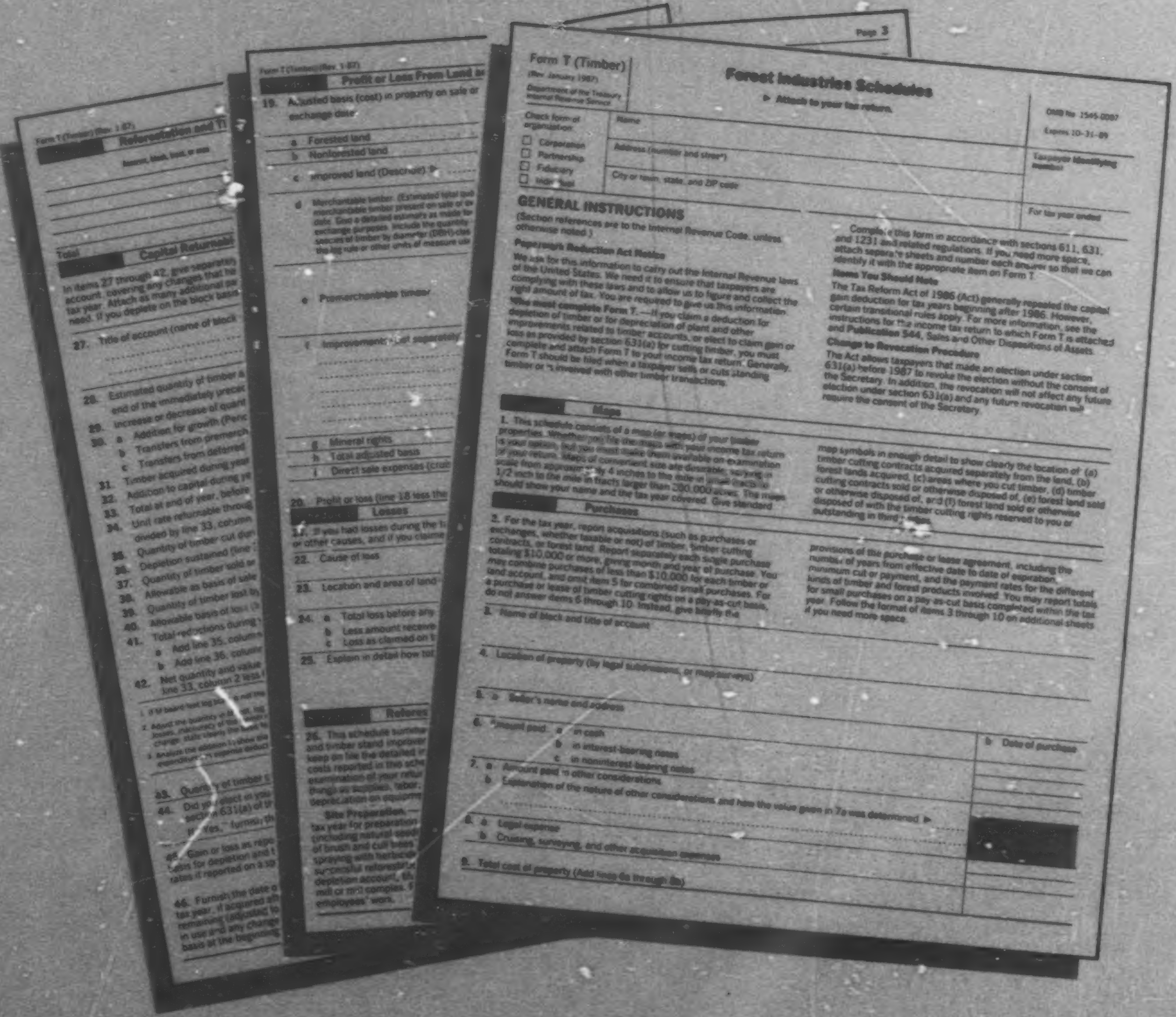
United States
Department of
Agriculture

Forest
Service

Agriculture
Handbook
No. 681

Forest Owners' Guide To Timber Investments, The Federal Income Tax, and Tax Recordkeeping



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Form T (Timber)
(Rev. January 1987)
Department of the Treasury
Internal Revenue Service

Forest Industries Schedules

▶ Attach to your tax return.

OMB No. 1545-0007
Expires 10-31-89

Check form of organization:
☐ Corporation
☐ Partnership
☐ Fiduciary
☐ Individual

Name

Address (number and street)

City or town, state, and ZIP code

Taxpayer identifying number

For tax year ended

GENERAL INSTRUCTIONS

(Section references are to the Internal Revenue Code, unless otherwise noted.)

Paperwork Reduction Act Notice

We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Who must complete Form T.—If you claim a deduction for depletion of timber or for depreciation of plant and other improvements related to timber accounts, or elect to claim gain or loss as provided by section 631(a) for cutting timber, you must complete and attach Form T to your income tax return. Generally, Form T should be filed when a taxpayer sells or cuts standing timber or is involved with other timber transactions.

Complete this form in accordance with sections 611, 631, and 1231 and related regulations. If you need more space, attach separate sheets and number each answer so that we can identify it with the appropriate item on Form T.

Items You Should Note

The Tax Reform Act of 1986 (Act) generally repealed the capital gain deduction for tax years beginning after 1986. However, certain transitional rules apply. For more information, see the instructions for the income tax return to which Form T is attached and **Publication 544**, Sales and Other Dispositions of Assets.

Change to Revocation Procedure

The Act allows taxpayers that made an election under section 631(a) before 1987 to revoke the election without the consent of the Secretary. In addition, the revocation will not affect any future election under section 631(a) and any future revocation will require the consent of the Secretary.

Maps

1. This schedule consists of a map (or maps) of your timber properties. Whether you file the maps with your income tax return is your option, but you must make them available on examination of your return. Maps of convenient size are desirable, varying in scale from approximately 4 inches to the mile in small tracts to 1/2 inch to the mile in tracts larger than 200,000 acres. The maps should show your name and the tax year covered. Give standard map symbols in enough detail to show clearly the location of: (a) timber cutting contracts acquired separately from the land, (b) forest lands acquired, (c) areas where you cut timber, (d) timber cutting contracts sold or otherwise disposed of, (e) forest land sold or otherwise disposed of, and (f) forest land sold or otherwise disposed of with the timber cutting rights reserved to you or outstanding in third parties.

Purchases

2. For the tax year, report acquisitions (such as purchases or exchanges, whether taxable or not) of timber, timber cutting contracts, or forest land. Report separately each single purchase totaling $10,000 or more, giving month and year of purchase. You may combine purchases of less than $10,000 for each timber or land account, and omit item 5 for combined small purchases. For a purchase or lease of timber cutting rights on a pay-as-cut basis, do not answer items 6 through 10. Instead, give briefly the provisions of the purchase or lease agreement, including the number of years from effective date to date of expiration, minimum cut or payment, and the payment rates for the different kinds of timber and forest products involved. You may report totals for small purchases on a pay-as-cut basis completed within the tax year. Follow the format of items 3 through 10 on additional sheets if you need more space.

3. Name of block and title of account

4. Location of property (by legal subdivisions, or map surveys)

5. a Seller's name and address

6. Amount paid: a in cash
b in interest-bearing notes
c in noninterest-bearing notes

b Date of purchase

7. a Amount paid in other considerations
b Explanation of the nature of other considerations and how the value given in 7a was determined ▶

8. a Legal expense
b Cruising, surveying, and other acquisition expenses

9. Total cost of property (Add lines 6a through 8b)

READEX FICHE best copy available

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Forest Owners' Guide to Timber Investments, the Federal Income Tax, and Tax Recordkeeping

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July 1989
Supersedes "A Guide to Federal Income Tax for Timber Owners," Agriculture Handbook No. 596, issued September 1982.

Abstract

Hoover, William L.; Siegel, William C.; Myles, George A.; and Haney, Harry L. Jr. 1989, Forest Owners' Guide to Timber Investments, the Federal Income Tax, and Tax Recordkeeping. Agriculture Handbook 681. Washington, DC: U.S. Department of Agriculture. 104 p.

Updates Agriculture Handbook No. 596, "A Guide to Federal Income Tax for Timber Owners," and incorporates changes made by the 1986 Tax Reform Act and the 1987 Revenue Act. Provides a framework for analysis of timber investments and a chapter on timber tax planning. Discusses Federal income tax considerations for timber including: capital costs, reforestation tax incentives, depreciation, operating expenses and the passive loss rules, timber capital gains, installment sales, casualty losses, alternative minimum tax, self employment taxes, and Christmas tree production. Chapters explain how to research tax questions, sources of tax assistance, and how to keep forest records. Blank tax and record forms, a glossary, and index are also provided.

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Chapter I. Introduction

Purpose

The purpose of this handbook is to encourage good forest management by presenting methods of analyzing forestry investments, and by explaining the Federal income tax as it pertains to timber. It also provides a system and blank forms to enable you to keep the necessary records for tax purposes and to more effectively manage your investment. This publication is a major revision of Agriculture Handbook 596, "A Guide to Federal Income Taxes for Timber Owners". The previous volume has been updated for changes made by the 1986 Tax Reform Act and the 1987 Revenue Act.

Since there is no longer a differential in effective rates between long-term capital gains and ordinary income, the section on timber capital gains has been modified. Passive loss is a new concept brought about by the 1986 Act; a new section on passive loss rules as they pertain to timber is added. A new section is also included on financial analysis of timber investments. Net present value, internal rate of return, and equal annual equivalent as related to timber investments are discussed to place timber taxation considerations in perspective with the total forestry investment.

The primary purpose of the handbook is to provide in one place the relevant information for analyzing a timber investment and the Federal income tax law associated with the investment. It does not provide guidance in establishing or managing a forest stand. That information is available from State forestry offices, the Agricultural Extension Service, private forestry consultants, and industry foresters.

Good records are necessary for both effectively managing a timber enterprise and reporting income and expenses for tax purposes. A section on recordkeeping has therefore been added to show how to record timber-related transactions. Forms are provided for recording expenses and income.

A new chapter, on researching a tax question, has been added to assist you or your tax advisor in understanding the relationship between statutory and administrative law. Audits and appeals procedures and how you take your case to court if you disagree with the Internal Revenue Service (IRS) are explained. A comprehensive example explains tax research procedures. Appendix I summarizes pertinent revenue rulings dealing with timber. Appendix II provides relevant tax forms. Appendix III provides forms for recording your timber transactions.

Sources of Assistance

Chapter IX lists sources of tax assistance. Local offices of the Internal Revenue Service can supply taxpayer publications to answer most questions you will have about income taxes. Foresters can provide assistance in determining timber values, establishing volumes, and developing management plans. You may wish to consult an accountant or attorney for the application of the law to your particular facts and circumstances, especially when the amounts involved are large or there is a particular tax problem.

Internal Revenue Service Review

This publication has been reviewed by the Internal Revenue Service, principally by its timber tax law specialist. It is not, however, to be construed as an official interpretation of the Internal Revenue Code or income tax regulations. It is intended to serve only as a guide for you and your tax advisor. Although the information in this publication is based on current law and regulations, many aspects of the new law are under review by the IRS and new regulations will be published as appropriate. You should consult the most current information for your individual case as outlined in Chapter VIII, Researching a Tax Question. The information in this publication is current as of March 1989.

Chapter II. Timber Investment Considerations

Is forestry a good investment? Most forest landowners would like to think so, and generally, growing timber can be a profitable enterprise. However, the final answer depends on the facts and circumstances in each case. The rewards of a forestry investment often come from satisfaction of ownership and a sense of pride from good stewardship of the resource. Such intangible benefits, which do not show up on the balance sheet as additional revenue, may help explain why owners are willing to hold timber investments. It is assumed in this chapter that you are interested in the economic returns of the forestry investment. The purpose of this chapter is to describe objective methods of evaluating forestry investment opportunities. These methods will be illustrated for a loblolly pine stand under management typical of the Southeastern United States.

Characteristics of a Timber Investment

Timber is a unique investment with several characteristics that are not typical of normal business situations. First, and most conspicuous, is the long growth (investment) period. Natural stands of southern pine frequently require an investment length of approximately 45 years from seed to harvest, a period known as a rotation. Eastern hardwoods need 60 to 80 years to produce quality sawtimber products. Many western species also require long rotations when managed in natural stands. On the other hand, intensive management of planted southern pine shortens the investment horizon to approximately 30 years depending on site productivity, cultural practices, and markets. Similarly, investments in intensive management shorten the rotation for hardwoods and western conifers; however, the rotation is still long. Energy (fuelwood) plantations which have projected harvest cycles of 5 to 15 years and Christmas trees, which typically range from 4 to 12 years in age at harvest, are exceptions. These opportunities are regionally important, but account for only a relatively small share of the overall timber investment potential.

The forest resource produces many benefits in addition to wood products. Among the multiple outputs that accrue to landowners are wildlife—both game and non-game species—natural beauty, outdoor recreation, and quality water. With the exception of hunting leases, owners rarely receive monetary returns from these outputs.

The harvest dates of timber products are more flexible than the harvest of annual crops. A harvest date which can be postponed for several years, in some cases, gives the timber owner the opportunity to wait for a more favorable price situation. A timber owner can plan to sell different timber products including firewood, pulpwood, sawtimber and veneer logs depending on price relationships. Within limits, timberland can be bought in acreages ranging from a few acres to thousands of acres and with timber age classes ranging from seedlings to mature timber to meet the needs of most investors.

Risk

Timber faces a variety of risks that do not affect more conventional investments. Also, timber resources are exposed to risks for a much longer time than are more conventional investments. Wildfire poses a threat to young plantations and to naturally grown conifer stands until they reach sufficient size for crown closure. Thereafter, risk from fire diminishes except where heavy buildups of fuel threaten a catastrophically hot fire. Quality hardwood forests are also at risk from fire, but their vulnerability decreases somewhat with age.

Adverse weather poses additional risks for forestry investments. Drought can kill seedlings established by artificial methods such as seeding or planting. Mortality also occurs in heavily stocked stands of intermediate age that are subjected to drought stress. Growing timber in ice, snow, and sleet belts may require modification of certain cultural practices. These conditions may restrict the range of plantation grown species. A moderate amount of destruction is also caused annually by windstorms and tornadoes.

Disease ranks as a more passive risk for forest management but one that can cause substantial problems if ignored. On the other hand, certain insects pose an immediate hazard and these risks often increase over time. Southern pine beetles and spruce budworm are examples of insects that respond to growth stress in maturing stands. Gypsy moth and other defoliators attack timber stands at any stage of stand development and risk of attack from them is not considered to be a function of time.

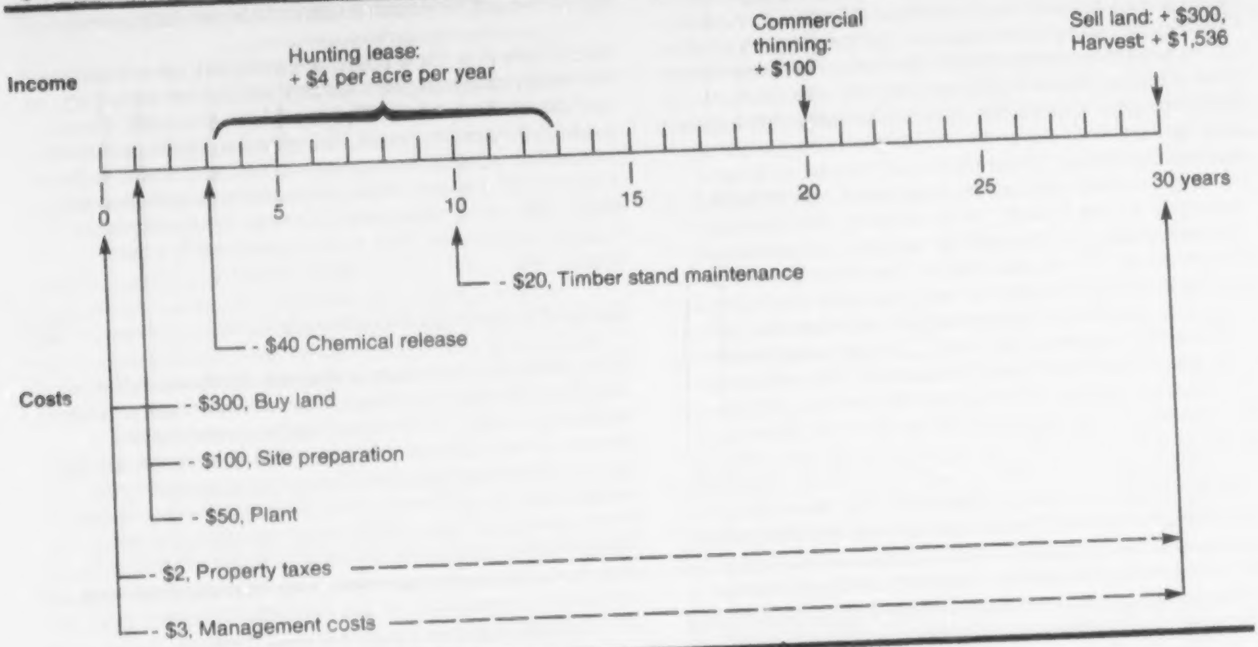
Although timber investments are subject to the same market risks as other investments, the risks are exacerbated by the long investment horizon. Costs and prices are affected by the expected future supply and demand of raw materials; whims in consumer preferences, and technological change. Some regional variations that must be considered include the availability of local timber markets.

Investment Expenditures

The way that investment expenditures are handled in an analysis depends on whether they are classified as capital expenditures, or as operating costs. A more detailed treatment of the tax treatment of both capital expenditures and operating costs is covered in Chapter V. Forestry capital expenditures that affect investment returns are:

Land—The capital cost of forest land and permanent improvements must be included when forestry investments are compared with alternative uses of investment funds (e.g., forestry vs. common stock). In the example shown in figure 1, the purchase price for cutover land is reported at

Figure 1—**Time Line for Timber Investment, Shown on a Per-Acre Basis in 1988 Dollars**



the beginning of the investment period at $300 per acre. Note that the terminal value of the land and permanent improvements is also shown as a revenue at the end of the investment period.

In some analyses of land use alternatives, it is appropriate to exclude the cost of land if it is owned and common to both alternatives under consideration. Examples include comparisons of forestry vs. agricultural uses, intensive forestry (planting) vs. extensive forestry (natural regeneration), and forests managed exclusively for timber vs. management exclusively for wildlife.

The evaluation should consider the total acreage, not just the net productive acreage, in order to accurately assess the expected returns from an investment opportunity. Typical tree farms may have as much as 25 percent or more of their surface area in roads, rights-of-way, water, and other nonproductive acres.

Important considerations when purchasing forest land include productivity (site index), operability (slope, soil conditions, etc.), accessibility (the nearness of roads), and location.

Merchantable timber—An adequate number of trees of desirable species must be present to realize the productive potential of the investment. If trees exist at the time of acquisition, as either merchantable timber or as young growth, a portion of the basis should be assigned to each according to their relative fair market values. The cost of establishing a timber stand, either following a harvest or in the conversion of open land, is also a capital expenditure. Included are costs of site preparation, planting or seeding, and any release of the seedlings from competing vegetation necessary for seedling survival.

Future timber products and volumes should be projected for analysis. Data for making projections are available from yield tables that are published by most land grant universities or state forestry organizations for the major species. Yield tables are also published regionally by the USDA Forest Service and in the south by the Tennessee Valley Authority. In addition, software packages for microcomputers are available from major land grant universities for most major timber species. These programs make it possible for you to simulate a wide range of results based on potential management decisions.

Annual Management Costs, Property Taxes, and Interest—The income tax treatment of "ordinary and necessary" forestry management expenses will depend on the classification of the activity under the passive loss rules as discussed in greater detail in Chapter V, page 20. Generally, the impact of the passive loss rules on investment returns depends on when deductions are allowed to be taken. In figure 1, annually recurring property taxes and management costs are shown as being currently deductible for this particular forestry investment. Similarly, the timber stand maintenance cost in year 10 is a single expense that is currently deductible.

Investment Revenues

All revenues that accrue to the land as a result of the landowner's investment and management activities should be included in the accounting.

Timber Sale—A timber sale is normally the primary revenue source for a forestry investment. Timber management cycles often include a final harvest as well as one or more intermediate harvests. For example, the thinning at age 20 (fig. 1) produces revenue of $100 per acre. For an investment analysis, revenues are based on the volume projections discussed above and on price information that may be obtained from a variety of sources. In the South, prices are reported monthly in Timber-Mart South as well as by several state services such as the Louisiana Forest Products "Quarterly Market Report." In the Midwest, the Wisconsin "Forest Product Price Review" gives price information for Wisconsin and Timber-Mart North covers Michigan. Price information is also available in other regions from the State Forester or the State Cooperative Extension Service. Note, however, that care must be exercised in applying reported prices to your particular timber investment. The influences of topography, timber quality, competition among prospective markets, and several other factors all have a bearing on price.

Hunting Leases—Hunting leases are one of the most important nontraditional sources of revenue from the forest. Annual revenues range from $.25 to $10.00 or more per acre—depending on location, size of the tract, and quality of the hunting. Additional capital outlays and management expenses may be necessary to obtain the highest lease rates. When multiple uses such as hunting leases are added to the forest investment, the benefits should be carefully weighed against the added cost outlays and any foregone timber income. An example of hunting revenues is illustrated in figure 1 with hunting income shown from years 3 through 13 at $4.00 per acre per year. Lease income is treated as ordinary income for federal income tax purposes.

Miscellaneous Revenues—Other income from the forest may include recreational fees for camping, livestock grazing fees, and mineral revenues. Intensive recreational uses of the forest often involve modifications of forestry practices and correspondingly increased costs. Similarly, mineral revenues may be substantial; however, such activities can involve sharply increased costs and/or impair timber site productivity. These high-risk opportunities should be analyzed separately from normal forestry investments on a case by case basis.

The above list is intended only to suggest the variety of costs and revenues that may be encountered during an analysis of potentially profitable timber tracts for purchase or management. The results of an analysis must be based on all of the economic factors that influence the outcome.

Economic Considerations

It is assumed here that the investor's objective is to analyze the financial return on a timber investment. There is no intent to evaluate personal non-financial objectives.

An individual's tax rate affects after-tax cash flows. The marginal tax rate (i.e., the rate applicable for the last dollar earned) is the appropriate one to use in the investment analysis. The marginal tax rate for capital gains revenue equals the ordinary income rate in 1988 and later years.

When Federal or State cost-share payments are available for forestry practices, tax treatment alternatives should be considered. See chapter VI, page 30, for a detailed discussion of these provisions. The net effect of the cost-share payment on after-tax income should be incorporated in the analysis. The benefits of the reforestation amortization and credit deductions (discussed in chapter V) should also be included in the cash flows under consideration where appropriate.

General Economic Trends

Most forestry costs change at the rate of inflation in the economy; however, stumpage prices may increase at rates exceeding inflation when supply/demand relationships change. These different price trends can cause miscalculations in investment analyses. Real price appreciation for some products such as southern pine and Douglas fir sawtimber stumpage has received much attention, but other product prices such as those for pine and hardwood pulp, and equipment costs, have also been affected. Predicting the future is hazardous, so use the best information available in predicting real changes in cash flows.

Inflation, through changes in the price level, affects all future cash flows. For example, the acquisition costs of land, timber, equipment, and reforestation are capitalized into the basis of the respective accounts in today's dollars. The basis (cost) is subtracted from revenue in inflated dollars at the time of asset disposal. The result is a lessening of the tax benefits of capital recovery over time. Therefore, after-tax analyses should be made in current terms (i.e., with inflation included) to avoid an inflation-induced overstatement of capital recovery benefits when using real cash flows (i.e., without inflation). Since all cash flows will reflect inflationary projections, caution should be exercised to be certain that the discount rate includes a factor for inflation. All elements of the analysis must be kept in comparable terms (i.e., with or without inflation; before or after tax).

Economic Decision Criteria

The analysis of long-term forestry investments requires taking into account the time value of money. Discounted cash flow techniques using compound interest satisfy that requirement. Obviously, one of the most important considerations affecting investment results is the choice of a discount or interest rate (terms sometimes used interchangeably). The investor is comparing the returns from forestry with the expected returns from the best alternative opportunities available. This is referred to as the investor's alternative rate of return. An investor's marginal tax rate is used to adjust alternative rates of return to an after-tax basis for analyzing after-tax cash flows.

Four decision criteria are commonly used by investors to decide if independent investment projects should be undertaken. The following paragraphs present only a brief overview of these four criteria. A comprehensive treatment of this subject is found in "Essentials of Forestry Investment Analysis" by Gunter and Haney, described on page 49.

Net Present Value (NPV)

All costs and revenues are discounted to the present at the investor's alternative rate of return. If the net result is positive, an investment should be undertaken. Among mutually exclusive alternatives (those in which the selection of one precludes selection of others) of similar risk, the investment with the highest NPV should be selected.

The Benefit/Cost Ratio (B/C).

All costs and revenues are discounted to the present at the investor's alternative rate of return and the ratio of discounted revenues divided by discounted costs is calculated. Projects with B/C ratios greater than 1:1 are profitable; projects are selected on the basis of the highest B/C ratio.

Internal Rate of Return (IRR)

IRR is the average compound interest rate that will be earned over the investment period. It is found by calculating the discount rate that makes the sum of discounted revenues and discounted costs equal to zero (i.e., the NPV will be zero). Mutually exclusive projects should be selected on the basis of the highest IRR, other things being equal.

Equal Annual Equivalent (EAE).

The EAE spreads the benefits and costs of an investment over its useful life in the same way that installment payments spread the cost of a loan over the payback period. This permits comparisons among projects such as a sawtimber rotation with a pulpwood rotation or with an annual crop. Projects with higher EAEs should be selected over those with lower EAEs.

Generally, the four criteria will rank investment projects similarly. However, the four criteria may rank projects differently under conditions where: (1) projects have different lives, (2) the cost of one project is larger than that of others, and (3) cash flows of one project increase over time while the others decline. In this case you should select the criteria that best meets your needs or possibly use other factors in selecting the project.

A number of microcomputer programs are available to landowners for analyzing forestry investments. Examples include the Quicksilver Forestry Investment Analysis Program and TWIGS, both available from the USDA Forest Service, and the Tennessee Valley Authority's Yield Program. These programs generally compute the decision criteria noted above, as well as others. Some packages also include growth and yield simulators for a variety of species. Again, good judgment should be exercised in fully understanding the assumptions of any model used.

Time Line

A time line is a diagram that helps you to visualize both the nature and the distribution of cash flows from forestry over the investment period (see fig. 1). Cost cash flows are shown with a minus below the time line. Revenue cash flows as shown with a plus above the time line. The cash flows may be single amounts that occur only once in the investment period. An example is the timber stand maintenance cost in year 10 of $20 per acre. Cash flows may also be periodic amounts that occur annually or at longer intervals. The property tax of $2 per acre is an example of an annual cost that recurs throughout the investment period. A review of the time line should insure that all cash flows that have a bearing on the analysis are properly recorded.

A Forest Investment Example

The procedure for evaluating an investment opportunity will be shown with an example intended to be typical of a management alternative that might be practiced in the Southeastern United States. Assume that a property for sale includes marginal agricultural land that has been idle for several years. The forestry potential of this land is illustrated with all costs and returns on a per acre basis.

The initial investment per acre includes land at $300, site preparation, $100, and planting, $50—all completed in the first year. A herbicide application of $40 is incorporated in year 3 to eliminate competing vegetation and thus ensure plantation establishment. These are all capital expenditures. In addition, annual property taxes of $2 and annual management costs of $3 are included. A further treatment at year 10 costing $20 is applied for timber stand maintenance. These are assumed to be currently deductible expenses for income tax purposes as described on page 20.

The revenue for this example in 1988 dollars includes hunting lease revenue of $4 per acre (ordinary income) in years 3 through 13 and a land sale of $300 in year 30. Timber revenue includes a thinning income of $100 at age 20 and a harvest income of $1,536 at age 30 (see table 1). All cash flows are adjusted for 4-percent inflation. In addition, timber revenues are adjusted for a 2-percent real price increase (see table 2). Prices are assumed to be $11 per cord for standing pulpwood and $135 per MBF for sawtimber. Expected price appreciation is based on USDA Forest Service projections of future price changes. Timber and land revenues are assumed to qualify for capital gains treatment.

Table 1—**Transactions for a Forest Management Example in the South, Per Acre**

No.	Activity	Year(s)	Current value	Rate of change	Quantity
			$/unit	%/year	
1.	Buy land	0	-300	0	1.00 acres
2.	Site preparation	1	-100	0	1.00 acres
3.	Planting	1	-50	0	1.00 acres
4.	Ad-val tax	1-30	-2	0	1.00 acres
5.	Management fee	1-30	-3	0	1.00 acres
6.	Herbicide	3	-40	0	1.00 acres
7.	TSI	10	-20	0	1.00 acres
8.	Use fees	3-13	4	0	1.00 acres
9.	Commercial thinning	20	11	2	9.10 cords
10.	Final harvest	30	11	2	8.40 cords
11.	Final harvest	30	135	2	10.69 MBF
12.	Land sale	30	300	0	1.00 acres

Table 2—**Cash Flows With Inflation and Taxes for the Investment Example**

Year	Cost	Cost with inflation	Benefits	Benefits w/ inflation	Taxes	Net income with tax	Net income w/o tax
			Dollars				
0	-300	-300	0	0	0	-300	-300
1	-155	-161	0	0	20	-141	-161
2	-5	-5	0	0	7	2	-5
3	-45	-51	4	4	12*	-34	-46
4	-5	-6	4	5	8	7	-1
5	-5	-6	4	5	8	7	-1
6	-5	-6	4	5	8	7	-1
7	-5	-7	4	5	8	7	-1
8	-5	-7	4	5	5	4	-1
9	-5	-7	4	6	2	1	-1
10	-25	-37	4	6	10	-22	-31
11	-5	-8	4	6	0	-1	-2
12	-5	-8	4	6	0	-1	-2
13	-5	-8	4	7	0	-1	-2
14	-5	-9	0	0	2	-6	-9
15	-5	-9	0	0	3	-6	-9
16	-5	-9	0	0	3	-7	-9
17	-5	-10	0	0	3	-7	-10
18	-5	-10	0	0	3	-7	-10
19	-5	-11	0	0	3	-8	-11
20	-5	-11	100	326	-88	227	315
21	-5	-11	0	0	3	-8	-11
22	-5	-12	0	0	3	-9	-12
23	-5	-12	0	0	3	-9	-12
24	-5	-13	0	0	4	-9	-13
25	-5	-13	0	0	4	-10	-13
26	-5	-14	0	0	4	-10	-14
27	-5	-14	0	0	4	-10	-14
28	-5	-15	0	0	4	-11	-15
29	-5	-16	0	0	4	-11	-16
30	-5	-16	1,836	9,994**	-2,710	7,268	9,978

*This value includes a 10 percent tax credit on both the inflated original cost and the herbicide treatment + [28 percent tax × 95% × (inflated costs and returns × 1/14 amortization the 1st and 8th years and 1/7 amortization in other years)].

**All costs and revenues, including land, are increased by 4 percent annual inflation. Timber revenues are increased by an additional 2 percent real price increase.

Timber yields are based on a loblolly pine growth and yield model for planted agricultural sites. The commercial thinning is expected to yield 9.1 cords per acre and the harvest clearcut at age 30, 10.69 thousand board feet (MBF) and 8.4 cords per acre.

It is also assumed that the taxpayer is married, is filing jointly and is in the 28 percent marginal tax bracket (i.e., 1988 taxable income is between $29,750 and $71,900); the long-term capital gains tax rate is also 28 percent. A summary of cash flows is shown in table 2, above. The example is analyzed for the reforestation amortization and credit options as discussed on page 17. No cost-share payments are included in the analysis.

To analyze the above costs and returns, it is helpful to organize the information on a time line as shown in figure 1 to be certain that all cash flows are included in the analysis. The calculations can be done with a hand calculator or the data can be entered in a computer program to analyze the investment using the previously described investment criteria as a guide.

Forestry investments are very sensitive to the discount rate because of the long time period between planting and harvest. The correct discount rate is the net after-tax rate you can get in the next best alternative. If the next best alternative is a tax free investment, such as a municipal bond, then the interest rate is used without adjustment as shown in table 3 for the 10 percent discount rate.

If the next best alternative is an investment, such as a corporate bond, that yields 10 percent annually with taxes subtracted before compounding, the correct discount rate is 7.2 percent (10 percent × (1 – .28 assumed tax rate)). Alternativly, if the next best alternative is an investment such as an individual retirement account (IRA), certain savings bonds, or alternative timber investments, where taxes are deferred until the end of the period rather than being subtracted before compounding, then the correct discount rate depends on the length of the investment period and when costs are incurred and revenues are received. Assuming an initial investment, 10 percent interest and a 28 percent tax subtracted at the end of 30 years, the approximate discount rate would be 8.8 percent.

The three discount rates discussed above are used to show the sensitivity of the analysis to the rate used. At lower discount rates most timber projects show positive returns. The net present value in this example is $482 at a 7.2 percent discount rate, but it declines to −$10 at a 10 percent discount rate (see table 3). Only projects with positive net present values are acceptable; therefore, you would not make this investment if you could get 10 percent tax-free elsewhere and you base the decision strictly on financial returns.

Table 3—**Analysis of the Forestry Investment Example**

Criteria Tax situation of best alternative	Discount rate	Criteria value after 28% tax
	Percent	
Net present value		
10% return with annual tax	7.2	$482
10% return tax deferred 30 years	8.8	154
10% tax free	10.0	-10
Benefit/cost ratio		
10% return with annual tax	7.2	$1.48:1
10% return tax deferred 30 years	8.8	1.17:1
10% tax free	10.0	.99:1
Equal annual equivalent		
10% return with annual tax	7.2	$40
10% return tax deferred 30 years	8.8	15
10% tax free	10.0	-1
Internal rate of return (before tax 11%)		10%

The benefit/cost ratios also are smaller at the higher discount rates. At a 7.2 percent discount rate, the benefit/cost ratio is $1.48 per $1.00 of present cost after tax, but at a 10 percent discount rate the present value of benefits is $.99 per present dollar of cost. Only projects with a benefit/cost ratio greater than 1:1 are acceptable so the timber investment would be accepted only if your decision was based on rates below 10 percent. The equal annual equivalent shows how much the investment would return each year. This value is useful for comparing timber returns with annual returns from farm crops. At a 7.2 percent discount rate, the EAE is equivalent to receiving a net after tax return of $40 per year over the investment period but only −$1.00 at the 10 percent rate. Only investments that yield positive EAEs are acceptable.

The internal rate of return is the calculated rate that the timber investment earns. It is therefore independent of the discount rate. The investment yields 11 percent before tax and 10 percent after tax. Acceptable IRR's should exceed the investor's alternative rate of return.

Summary

A forestry investment must be analyzed within the context of your personal goals. Because these investments are long-term, an objective decision framework that takes into account the time value of money is required. The investment criteria give appropriate results, but the results are no better than the accuracy of the costs, revenues and discount rates used. Therefore, expected values of each economic variable should be chosen carefully.

Forestry investment decisions are always made on the basis of limited information because no one can see into the future. Examples given to illustrate the analysis are valid only for the specific assumptions and information used here; however, the method is applicable to a wide variety of investment situations. This framework allows you to compare forestry with other investment alternatives on an objective basis if all information affecting the outcomes is considered. Good judgment fostered by experience is essential for tempering the choice of inputs and for evaluating the results while including intangibles and personal considerations.

Chapter III. Tax Planning

The Planning Team

Achieving the maximum potential from your timber property requires the development and implementation of an integrated forest management, estate, and financial plan. Depending on the complexity of your circumstances, and your willingness to become personally involved in the timber, legal, financial and tax aspects, you may need the technical expertise of a consulting forester, accountant, lawyer, or other investment advisors. The role for each of these individuals is discussed in the context of the planning considerations that should be made.

Developing an Integrated Plan

Introduction

The financial objective for your timber activity should be to maximize the after-tax return on the funds you have committed for the benefit of whomever you desire. If your objective is to merely enjoy your timber property, your activity most likely constitutes a hobby and should be treated accordingly for tax purposes. Personal enjoyment and profitability are not incompatible goals, but any expenditures you make which do not contribute directly and materially to the profitability of your activity may not receive favorable tax treatment.

Tax planning does not mean tax avoidance. Rather, it means arranging your affairs so that you pay only the taxes required by law.

Advantages of Timber Investments

Timber investments as a rule are not tax shelters since, among other things, you can't deduct more than your out-of-pocket investment in the activity, and borrowing on timberland is seldom available. In fact, many expenditures must be carried in a timber account for years before being recovered.

For a given level of risk, timber property may increase the return to your overall investment portfolio. It appreciates in value due to growth in volume, increase in quality, and long-run real price increases. Timber property may serve as an inflation hedge because it provides considerable flexibility in harvest dates. Income realization can be timed to meet cash needs because, within limits, cutting can be delayed or accelerated, thus affecting tax liability in a given year. Timber provides a financial reserve to meet cash needs.

Estate Planning Role

Timberland is often a good candidate for short-term trust or intergenerational joint ownership. Forest property is also a good candidate for a family gift program to reduce the gross estate value to less than the taxable estate value and where it is desired to spread income tax liability among family members. Timberland estates may qualify for special use valuation (Section 2032A of the Internal Revenue Code) and deferral and installment payment of estate tax (Sec. 6166). Timber as a renewable resource can provide funds to help cover transfer tax liabilities without having to liquidate nonrenewable family business assets.

Planning Implications

Various timber characteristics lend themselves to specific planning implications.

Substantial Initial Investment—The acquisition of timber generally requires a substantial initial investment with little possibility of immediate cost recovery, unless merchantable timber is acquired. To minimize the time over which this cost must be carried you should ensure that the proper portion of the available basis is allocated to those assets that will be disposed of first, and amortize qualified reforestation expenditures.

Long Preproductive Period—Consider structuring your activity to allow the deduction of qualified expenses against other income where appropriate.

Multigenerational Investment Horizon—Timber can be used as the component of a portfolio designed to accumulate wealth for transfer to heirs. You should arrange your affairs to minimize liability for estate and other transfer taxes. For example, transfer of timber at your death rather than during your lifetime has the advantage that when your heir disposes of the timber the basis is the fair market value at your death rather than your original basis.

Tax Considerations When Timberland is Purchased

It may be helpful for you to develop and maintain in your files a management plan documenting your intention to manage the property for profit, and to include an estimate of projected profit. Establish accounts to which the costs of acquisition are allocated according to the relative fair market value of the various components of the property acquired. File for property tax relief if special forest property tax laws exist in your state.

Tax Considerations When Selling Timber

Maximize after tax income by paying income tax only on your "gain" on the timber, where Gain = Sales receipts − Cost of sale − Allowable basis of timber, and report net income as a long-term capital gain if it qualifies. Consider deferring receipt of a portion of the sale proceeds only if the resulting tax savings exceeds the opportunity cost of not having use of the deferred funds.

Chapter IV. General Tax Considerations

Types of Forest Ownership and Operation.

How you may treat the expense and income items associated with your timber property depends on your use of the property, the type of taxpayer with which the property is associated, and the nature of the item itself. For example, property tax paid is always deductible by individuals simply because it is included in the list of allowable itemized deductions for individuals. Property tax is also a deductible investment or business expense. Expenses for protecting your property from fire, however, can be deducted only if you hold the property for the production of taxable income as an investment or business.

Income you receive in the form of hunting or other fees is ordinary income under all types of ownership. Income from the disposition of timber, however, may qualify for long-term capital gain treatment. Such treatment depends on how the timber is disposed of and whether or not it is part of a trade or business, as discussed in chapter VI.

Purpose for Holding Timber

Timber property can be held for three basic purposes or some combination of them:

Personal use—Property not used to produce income is held for personal use. The house and land that serve as your residence are examples. Even though you might expect to sell them some day for more than you paid for them, your primary reason for holding them is to give you a place to live. Likewise, you may own forest property mainly for your personal use as a site for a second home or for recreation.

Investment—Property used to produce income may be investment property rather than a trade or business. If timber production is not your principal source of income, but you otherwise manage your property for the eventual realization of a profit, you may be holding your property as an investment. If you are an absentee owner you may qualify as an investor if your timber related activities are motivated primarily by profitability and not for other purposes.

Business—Property is held for use in a trade or business if it is part of an activity entered into and carried out for profit on a more regular basis than in the case of an investment. In addition, you may be holding your timber "primarily for sale" to customers in the ordinary course of a trade or business. Two characteristic elements of a business are regularity of activities and transactions, and the production of income. (See Publication 334, "Tax Guide for Small Business," chapter 1.) Your relationship with any trade or business in which you own an interest is considered to be either "active" or "passive" in nature.

Active business interest—You are actively engaged in a trade or business if you "materially participate" in conducting it. To materially participate, you must personally participate on a regular, continuous and substantial basis in the conduct of the activity.

Passive business interest—Your relationship with your trade or business is passive if you do not materially participate in its conduct. These distinctions are discussed in more detail in chapter V.

The determination of your primary reason for holding a particular forest property is based on all the facts related to your intended and actual use of the property. No single factor is controlling, but your activities at the time of determination are very important.

Types of Taxpayers

The two basic types of taxpayers are individual and corporate. An individual engaged in a trade or business as a sole proprietor reports most income and all expenses on either Schedule C or Schedule F of Form 1040. The net income (loss) from these forms is transferred to the first page of Form 1040 for inclusion in the taxpayer's gross income.

Certain corporations may elect to be taxed like a partnership. Corporations making this election are referred to as S corporations. Those not making the election are referred to as C corporations. Although partnerships and S corporations file tax returns, they are information returns only. These entities do not pay taxes themselves. Information returns report the income and other tax items associated with the activity for the year and how these items are to be distributed (passed through) to the individual or corporate owners of the activity. Income from all sources is consolidated on the individual or corporate tax return, and the appropriate individual or corporate tax rate is then applied to total taxable income. Individual taxpayers report their portion of partnership or S corporation income (loss) on Form 1040, Schedule E. Net income (loss) from Schedule E is then transferred to the first page of Form 1040 for inclusion in the taxpayer's gross income.

Estates and trusts represent a special case. They may or may not pay income tax as separate taxable entities. See Publications 448, "Federal Estate and Gift Taxes," and 559, "Tax Information for Survivors, Executors, and Administrators."

Structuring Your Timber Activities

How your timber related activities are classified for tax purposes—that is, their structure—is generally dictated by their scope and nature. If you own a small acreage and have only occasional transactions, you are most likely treating the activity for tax purposes as an investment. If your holdings generate fairly regular and continuous transactions, your activities may constitute a business. If so, you should evaluate which structure your business should have to best achieve your objectives. In many cases you will treat it as a sole proprietorship. If your family is involved you may want to execute a partnership agreement, or incorporate. Tax considerations, although important, are usually not the primary factor determining the best structure. This determination should be made after careful consultation with your legal, financial and forestry advisors.

Note that joint ownership of property does not necessarily create a partnership for tax purposes. A partnership for tax purposes exists if there is a joining together of two or more "partners" to carry on a trade or business, with each contributing to the venture, and each expecting to share in the profits and losses of the business.

Chapter V. Cost Considerations

Capital Costs

For Federal income tax purposes, your expenditures as a forest owner may generally be classified as one of three types: (a) capital costs, which include those that are recoverable through allowances for depreciation or amortization, as well as those which must be added to basis and are recoverable only when the asset is sold or otherwise disposed of; (b) currently deductible expenditures for management costs, taxes and interest; and (c) costs of sale. The first two types are discussed in this chapter; costs of sale are discussed in Chapter VI.

Money spent to acquire real estate or equipment, or to make improvements that increase the value of real estate or equipment already owned, is classified as a capital cost. Examples of capital expenditures are purchases of land, timber, buildings, and of machinery and equipment having a useful life of more than one year. Other examples include funds expended for construction of bridges, roads, and firebreaks; for site preparation, tree planting, and seeding; and for major repairs that prolong the life of machinery and equipment. All costs associated with the purchase, planting, or seeding of timber are capital expenditures. Generally speaking, the owner of property whose costs must be capitalized—if they are associated with an income producing activity—is entitled to offset or deduct the amount of investment in such property against income arising from it—and in some cases, against income from other sources.

Capital costs usually cannot be deducted from income in their entirety in the year they are incurred. Instead they must be used to establish or add to a capital account. This process of recording costs in an account so that they may be recovered over a period of years as the property is used up or worn out, or upon disposition of the property, is called "capitalization." At any given time the dollar value recorded in each account represents the amount of unrecovered costs currently invested in property for that account. The basic rules governing which timber-related costs must be capitalized remained unchanged following the 1986 Tax Reform Act. The new law did make some changes, however, in certain of the methods of capital cost recovery. These will be discussed in later sections of this chapter.

Original and Adjusted Basis

When a capital asset is first acquired, the amount to be entered into the account for that particular asset depends on how the property was obtained, as discussed in the following paragraphs. This amount is the original basis of the acquired property. The original basis may change as capital improvements are made to the asset—or as allowances for depletion, amortization or depreciation are deducted. Capital improvements will increase the original basis; allowances for depletion, amortization, and depreciation will decrease it. Procedures for making these changes are discussed in detail in chapter X. The balance remaining in an account at any point in time after one or more changes have been made to the original basis is called the adjusted basis.

Purchased Assets—If a capital asset is purchased, the original basis is its acquisition cost. This is the first entry to be placed in the capital account for that particular item.

Inherited Assets—The original basis of an inherited asset is its fair market value on the date the decedent died or on the alternate valuation date provided by Federal estate tax law. The alternate valuation date, if elected, is the earlier of 6 months after the decedent's death or the date an estate asset is sold. This value is usually greater than the decedent's basis. Passing title by inheritance, therefore, generally results in a "stepped-up" basis for the property in the hands of the new owner, which could result in large income tax savings upon disposal of the property. If the estate was not required to file a Federal estate tax return, the appraised value at the date of death for State death tax purposes should be used. Otherwise, use the fair market value of property at date of death.

Assets Received by Gift—In most instances, the original basis of an asset received by gift is based on the donor's adjusted basis. This is the case when the fair market value of the gift at the time it is made is more than the donor's adjusted basis—which is the usual situation. For pre-1976 gifts of this type, the new original basis is the donor's adjusted basis plus the entire amount of the gift tax paid, if any, not to exceed the fair market value of the gift when made. For such gifts made after 1976, that portion of the gift tax applicable to the difference between the donor's adjusted basis and the gift's fair market value at the time of the gift is added to the donor's adjusted basis. If the fair market value of a gift at the time it is made is less than the donor's basis, then the donee's original basis for loss purposes is the fair market value.

Other Types of Acquisition—Other, less common ways of acquiring property include non-taxable or partly taxable exchanges, and replacement of involuntarily converted property—such as that damaged or destroyed by casualty or lost by theft. For a discussion of these types of situations, see IRS Publication 551, "Basis of Assets."

Allocation of Original Basis—Sales contracts and other instruments transferring forest property often do not list separate prices or values for the land, timber, and other assets when these are acquired in a single transaction. The total basis in such situations must be allocated among the various assets according to the separate fair market value of each at the time the property is acquired. Example 1 explains the allocation procedure. This requirement applies no matter when the allocation is actually made—even if it is done many years after the acquisition. If the timber represented a significant part of the total value of the property when it was acquired, but its quantity and value as of that date are unknown, you will probably need a forester's help to make these determinations. Only timber with a fair market value as of the date of acquisition should be included in the basis valuation. This means that if the determination is being made after the acquisition date, the present timber volume must be reduced by the amount of growth that has occurred since the timber was acquired.

Accounts Established

Land Account—Assets that are placed in the land account include the land itself and non-depreciable land improvements. Non-depreciable land improvements include earthwork assets of a permanent character, either acquired with the property or constructed later. Examples are the roadbeds of permanent roads (those with an indeterminable useful life to the landowner); land leveling; and earthen impoundments. The basis of such assets, like that of the land itself, can only be recovered when you sell or otherwise dispose of the land.

Depreciable Land Improvements—Depreciable land improvements may include bridges, culverts, graveling, fences, fire towers, and other nonpermanent structures and improvements. Temporary roads, such as those to be abandoned after completion of a logging operation, may also be depreciated (or amortized). The costs of firebreak construction are treated the same as the expenses of constructing temporary roads. Depreciation is discussed in greater detail later in this chapter.

Timber Accounts—The timber account should include separate subaccounts for merchantable timber, young growth (naturally seeded trees of premerchantable size), and plantations (planted or seeded trees of premerchantable size). Additional accounts can also be established using other criteria such as species and location. Each of these subaccounts should include two entries—one showing the quantity of timber and the other its dollar basis. For merchantable timber, the quantity is shown in volume measurement terms such as cords or thousand board feet (MBF). For premerchantable timber, the quantity is shown as number of acres. At the time timberland is acquired, a reasonable amount of the basis should be allocated to young growth if it contributes to the overall value of the property.

The procedure outlined in example 1 should be used. It is important to remember that the basis allocation must be made with reference to the relative fair market values of the various assets at the time the property is acquired. If only cutting rights are acquired, all costs related to the acquisition should be charged to the timber account.

The quantity of merchantable timber to be entered in the timber account as of the date of acquisition should be the volume that the tract would have produced if all of the merchantable timber had been cut and processed at that time in accordance with the prevailing utilization standards in the locality. As explained above, the quantity of merchantable timber should be expressed in terms of thousand board feet, cords, or some other standard unit of timber measure.

The plantation and young growth subaccounts reflect the establishment of timber stands by planting, or by natural or artificial seeding (see summary of Revenue Ruling 75–467, page 63). As mentioned above, all timber establishment costs are required to be capitalized. Establishment costs include funds spent to prepare a site for tree planting or seeding and for the cost of the seedlings or tree seeds. Site preparation costs are those incurred for brush, weed, and stump removal; and for leveling and conditioning the land to afford good growing conditions and to facilitate planting or seeding.

Other related costs that must be capitalized include the allocable depreciation charges attributable to equipment used in site preparation and planting or seeding—such as trucks, tractors, and tree planters. The cost of hired labor associated with reforestation must also be capitalized. The term "hired labor" includes family members who are actually paid for their services, but it does not include yourself. In certain cases, "hired labor" may also include your spouse. You, as a taxpayer, cannot capitalize the cost of your own labor. Establishment costs may also include some expenditures made after seeding or planting, such as for brush control, because a stand is not considered established until a number of individual stems sufficient to adequately stock the site with the desired species are capable of surviving. (See summary of Revenue Ruling 76–290, page 63).

The costs of replanting or reseeding after seedling mortality, such as death by drought, also have to be capitalized. Depending on the cause of death, you may be able to claim the loss as an income tax deduction as explained later in chapter VII.

Capitalized reforestation costs in a tax year to a maximum of $10,000 may be recovered by being immediately amortized over a period of 84 months rather than by waiting to deduct them from sale proceeds when the timber is cut or otherwise disposed of. The amortization procedure is described later in this chapter, whereas deductions against sale proceeds are discussed in chapter VI.

Volume and value entries from the young growth and plantation subaccounts should be transferred to the merchantable timber subaccount as soon as the trees in those two subaccounts become merchantable. The dollar amount and the number of units are added directly to the merchantable timber account as shown in example 2.

Equipment Accounts—Accounts also have to be established for depreciable equipment and machinery. This will usually consist of a subaccount for each item or class of items—such as powersaws, tractors, trucks, and planting machines. The basis of such items should be adjusted (increased) by any amounts spent for major repairs that significantly increase their value or prolong their life. The basis of machinery and equipment is recovered through depreciation allowances as discussed later in this chapter.

Example 1

Establishing land and timber accounts: You bought a 100-acre tract of timberland in 1986. The contract price was $41,000, but you also paid $800 to have the boundaries surveyed, $200 for a title search and filing, and $1,800 to have the timber cruised and evaluated. Therefore, your total acquisition cost was $43,600.

The timber cruise conducted at the time you made the purchase determined that the tract contained 1,000 cords of merchantable pine pulpwood on 90 acres. There were also 10 acres of young growth (trees of premerchantable size) that contributed to the value of the property. The fair market value of the timber on the date of purchase was $18 per cord. The young growth had a fair market value of $125 per acre. The fair market value of the land itself, not considering the timber, was $200 per acre. Therefore, the sum of the separate fair market values of all of the assets purchased was $39,250. In this case, as is often the situation, the total of the separate fair market values of the various assets purchased does not equal the total acquisition cost.

Now, you can figure your original cost basis for the land, merchantable timber, and young growth by determining the proportion of the total fair market value represented by each and multiplying this ratio by the total acquisition cost. For example, dividing the fair market value of the merchantable timber by the total fair market value, $18,000/$39,250 = 0.4586, and multiplying by the total acquisition cost, 0.4586 × $43,600, gives an original cost basis of $19,995 for the merchantable timber. The original cost basis for each of the assets is shown in the following tabulation, and reported on Schedule B of Form T (fig. 2).

Determination of Cost Basis

Asset	Fair market value	Proportion of total fair market value	Original cost basis
Land	$ 20,000	0.5096	$ 22,219
Young growth	1,250	0.0318	1,386
Merchantable timber	18,000	0.4586	19,995
Total	$ 39,250	1.0000	$ 43,600

Example 2

Adjustment of timber accounts: In 1987 you remeasure the timber you bought in example 1. You determine that the young growth has reached merchantable size and contains 80 cords. Therefore, you transfer the dollar amount shown in the young growth subaccount and the estimated number of units to the merchantable timber subaccount. The closing 1987 (opening 1988) balance in the merchantable timber subaccount is, therefore, $21,381 ($19,995 plus $1,386). The balance in the young growth subaccount is reduced to $0. The remeasurement also indicated that the timber on the 90 acres grew by 200 cords. Report the transfer on Schedule F of Form T (fig. 3).

Reforestation Tax Incentives

Qualified reforestation (or afforestation in the case of planting nonforest land) expenditures paid or incurred in a tax year to a maximum of $10,000 are eligible for a 10 percent investment tax credit and for amortization (deduction) over an 84 month period. This favorable treatment was provided by Public Law 96–451, which was codified in Sections 194 and 48 of the Internal Revenue Code. It is an exception to the general rule that capitalized reforestation costs are recoverable only when the timber is disposed of.

Expenditures for timber-stand-improvement practices in established stands do not qualify for the amortization and tax credit, but they may be deducted as an expense in the year incurred or else capitalized as discussed on page 19.

Qualified reforestation expenditures are the direct costs you incur in connection with establishing a stand of timber—whether by planting, seeding, or natural regeneration as discussed on page 12. Only $10,000 ($5,000 for married persons filing separately) of reforestation expenditures in any tax year is eligible for amortization and the tax credit. There is no carry-over of expenditures exceeding $10,000 to subsequent years or carryback to previous years. The excess capitalized costs are capitalized to the plantation subaccount.

Reforestation expenses incurred under the Conservation Reserve Program (CRP) may be eligible for the tax credit and amortization. As an alternative, if you are engaged in the business of farming, some or all CRP expenses may be deducted annually under Code Section 175. This section provides that you may deduct certain soil and water conservation expenses that would otherwise have to be capitalized. In order to be deductible, expenses must be consistent with a plan approved by the U.S. Soil Conservation Service office for the area where the land is located or by a comparable State agency. There is a limit on the amount that can be deducted in any one year of 25 percent of your gross income from farming during the year.

Individuals, estates, partnerships, and corporations are eligible for either or both the amortization and credit. Trusts are not eligible for either. The $10,000 annual limit applies to both the partnership and to each partner, and to both the S corporation and each shareholder. Thus, a partner's or shareholder's total annual amortizable reforestation expenditure from all sources cannot exceed $10,000.

To qualify for the reforestation amortization and credit, your reforested timber property must be of at least 1 acre in size and located in the United States. The site must contain trees in significant commercial quantities and must be held by you for planting, cultivating, caring for, and cutting of trees for sale or for use in producing commercial timber products. A taxpayer who incurs qualified reforestation costs on either owned or leased property qualifies.

Christmas tree planting expenditures do not qualify for either the credit or the amortization. The costs of trees

Figure 2—**Schedule B of Form T (Timber)**

Form T (Timber) (Rev. January 1987) Department of the Treasury Internal Revenue Service	**Forest Industries Schedules** ▶ **Attach to your tax return.**	OMB No. 1545-0007 Expires 10-31-89
Check form of organization ☐ Corporation ☐ Partnership ☐ Fiduciary ☐ Individual	Name Address (number and street) City or town, state, and ZIP code	**Taxpayer identifying number** For tax year ended

GENERAL INSTRUCTIONS

(Section references are to the Internal Revenue Code, unless otherwise noted.)

Paperwork Reduction Act Notice

We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Who must complete Form T.—If you claim a deduction for depletion of timber or for depreciation of plant and other improvements related to timber accounts, or elect to claim gain or loss as provided by section 631(a) for cutting timber, you must complete and attach Form T to your income tax return. Generally, Form T should be filed when a taxpayer sells or cuts standing timber or is involved with other timber transactions.

Complete this form in accordance with sections 611, 631, and 1231 and related regulations. If you need more space, attach separate sheets and number each answer so that we can identify it with the appropriate item on Form T.

Items You Should Note

The Tax Reform Act of 1986 (Act) generally repealed the capital gain deduction for tax years beginning after 1986. However, certain transitional rules apply. For more information, see the instructions for the income tax return to which Form T is attached and **Publication 544**, Sales and Other Dispositions of Assets.

Change to Revocation Procedure

The Act allows taxpayers that made an election under section 631(a) before 1987 to revoke the election without the consent of the Secretary. In addition, the revocation will not affect any future election under section 631(a) and any future revocation will require the consent of the Secretary.

Schedule A Maps

1. This schedule consists of a map (or maps) of your timber properties. Whether you file the maps with your income tax return is your option, but you must make them available on examination of your return. Maps of convenient size are desirable, varying in scale from approximately 4 inches to the mile in small tracts to 1/2 inch to the mile in tracts larger than 200,000 acres. The maps should show your name and the tax year covered. Give standard map symbols in enough detail to show clearly the location of: (a) timber cutting contracts acquired separately from the land, (b) forest lands acquired, (c) areas where you cut timber, (d) timber cutting contracts sold or otherwise disposed of, (e) forest land sold or otherwise disposed of, and (f) forest land sold or otherwise disposed of with the timber cutting rights reserved to you or outstanding in third parties.

Schedule B Purchases

2. For the tax year, report acquisitions (such as purchases or exchanges, whether taxable or not) of timber, timber cutting contracts, or forest land. Report separately each single purchase totaling $10,000 or more, giving month and year of purchase. You may combine purchases of less than $10,000 for each timber or land account, and omit item 5 for combined small purchases. For a purchase or lease of timber cutting rights on a pay-as-cut basis, do not answer items 6 through 10. Instead, give briefly the provisions of the purchase or lease agreement, including the number of years from effective date to date of expiration, minimum cut or payment, and the payment rates for the different kinds of timber and forest products involved. You may report totals for small purchases on a pay-as-cut basis completed within the tax year. Follow the format of items 3 through 10 on additional sheets if you need more space.

3. Name of block and title of account

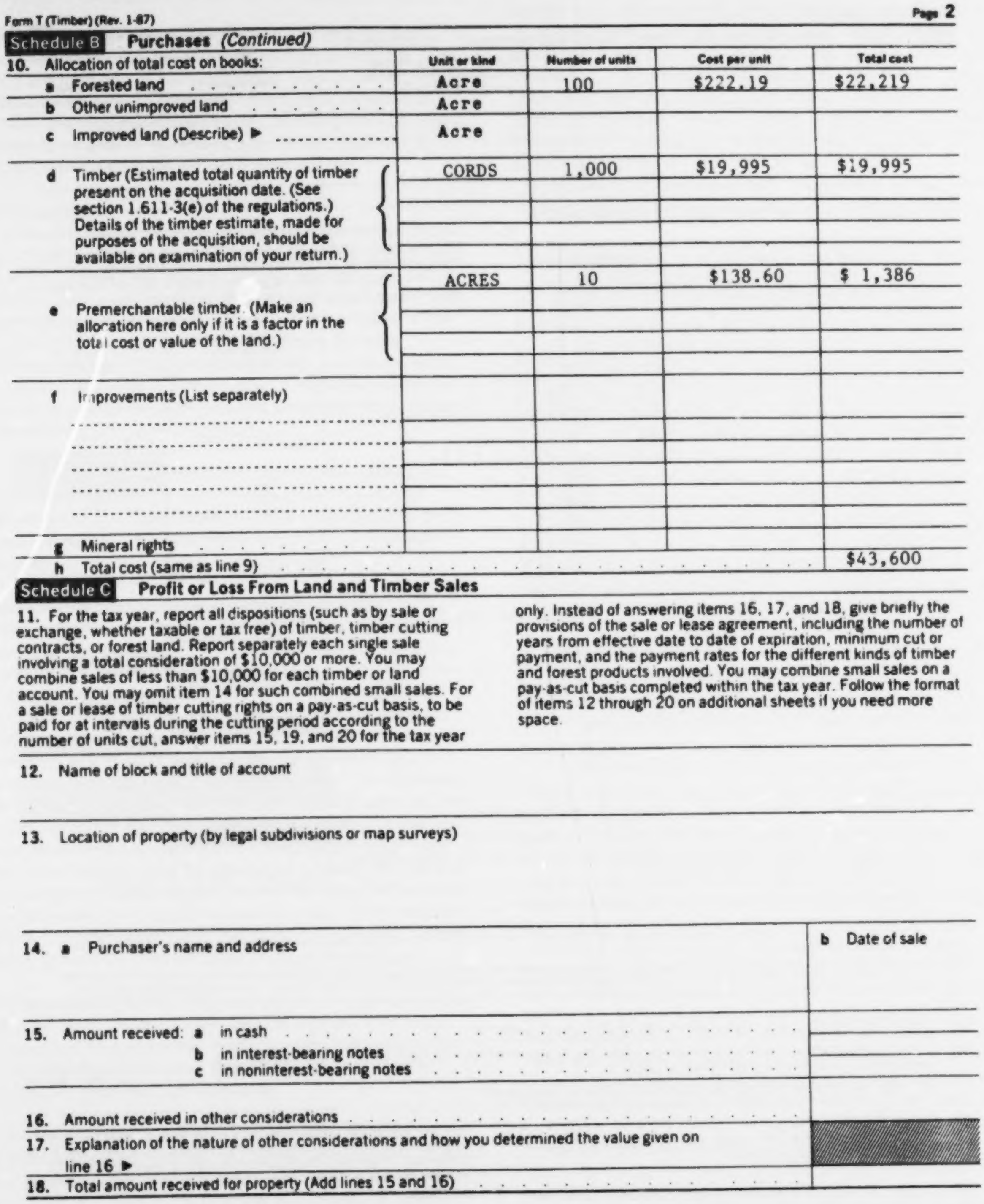
`(YOUR NAME) TIMBER ACCOUNT`

4. Location of property (by legal subdivisions, or map surveys)

`W 1/2 OF NE 1/4 OF SECTION 5, AND W 1/2 OF SE 1/4 OF NE 1/4 OF SECTION 5, SPRING TOWNSHIP, PINE COUNTY ALABAMA`

5. a Seller's name and address (TO BE COMPLETED)	b Date of purchase Oct. 2, 1986
6. Amount paid: a in cash	$41,000
b in interest-bearing notes	
c in noninterest-bearing notes	
7. a Amount paid in other considerations	0
b Explanation of the nature of other considerations and how the value given in 7a was determined ▶	▨
8. a Legal expense	200
b Cruising, surveying, and other acquisition expenses	2,400
9. Total cost of property (Add lines 6a through 8b)	43,600

Figure 2—Continued



Form T (Timber) (Rev. 1-87) Page 2

Schedule B **Purchases** *(Continued)*

10. Allocation of total cost on books:	Unit or kind	Number of units	Cost per unit	Total cost
a Forested land	Acre	100	$222.19	$22,219
b Other unimproved land	Acre			
c Improved land (Describe) ▶	Acre			
d Timber (Estimated total quantity of timber present on the acquisition date. (See section 1.611-3(e) of the regulations.) Details of the timber estimate, made for purposes of the acquisition, should be available on examination of your return.)	CORDS	1,000	$19,995	$19,995
e Premerchantable timber. (Make an allocation here only if it is a factor in the total cost or value of the land.)	ACRES	10	$138.60	$ 1,386
f Improvements (List separately)				
g Mineral rights				
h Total cost (same as line 9)				$43,600

Schedule C **Profit or Loss From Land and Timber Sales**

11. For the tax year, report all dispositions (such as by sale or exchange, whether taxable or tax free) of timber, timber cutting contracts, or forest land. Report separately each single sale involving a total consideration of $10,000 or more. You may combine sales of less than $10,000 for each timber or land account. You may omit item 14 for such combined small sales. For a sale or lease of timber cutting rights on a pay-as-cut basis, to be paid for at intervals during the cutting period according to the number of units cut, answer items 15, 19, and 20 for the tax year only. Instead of answering items 16, 17, and 18, give briefly the provisions of the sale or lease agreement, including the number of years from effective date to date of expiration, minimum cut or payment, and the payment rates for the different kinds of timber and forest products involved. You may combine small sales on a pay-as-cut basis completed within the tax year. Follow the format of items 12 through 20 on additional sheets if you need more space.

12. Name of block and title of account

13. Location of property (by legal subdivisions or map surveys)

14. a Purchaser's name and address

b Date of sale

15. Amount received: a in cash

b in interest-bearing notes

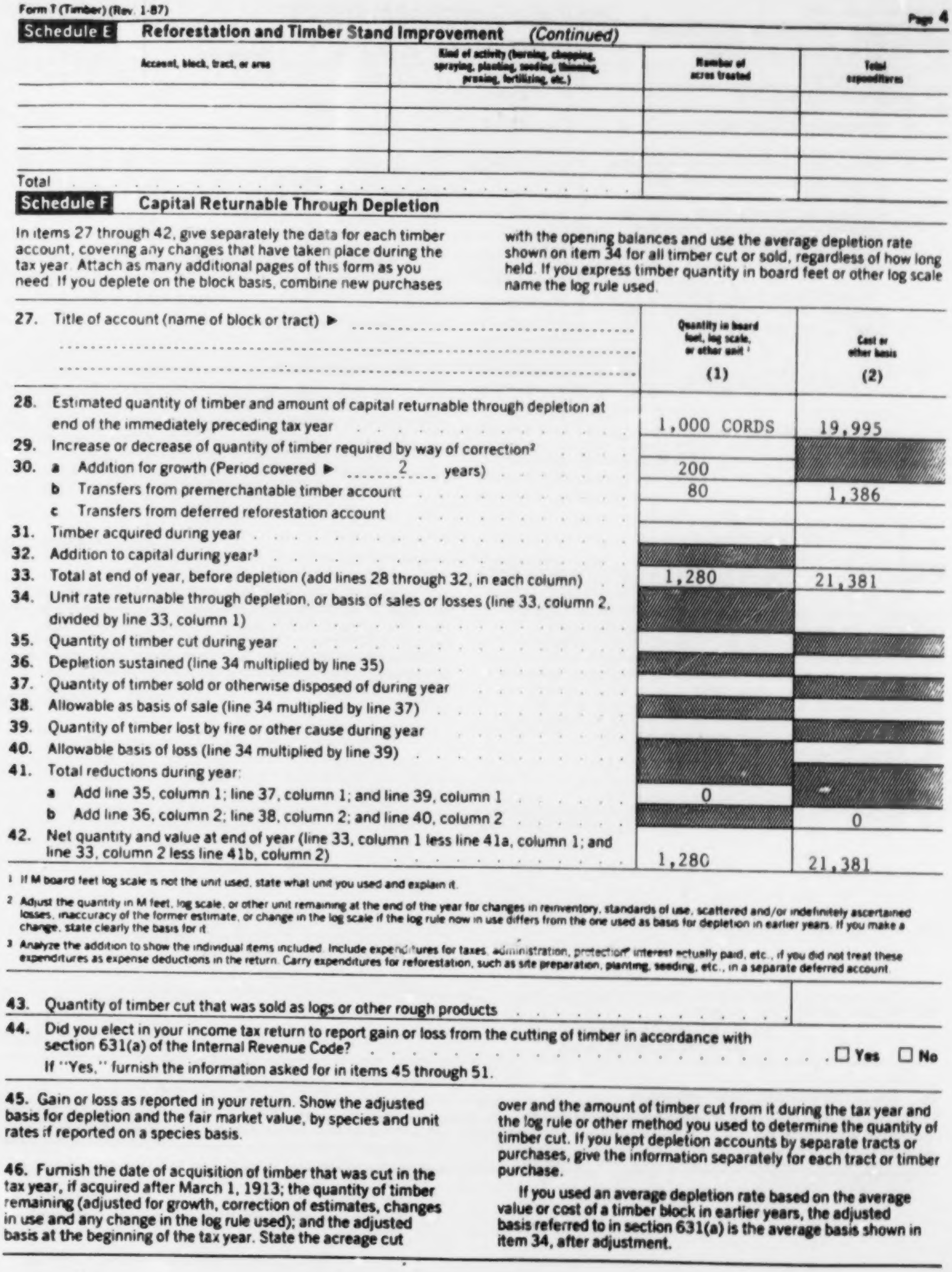
c in noninterest-bearing notes

16. Amount received in other considerations

17. Explanation of the nature of other considerations and how you determined the value given on line 16 ▶

18. Total amount received for property (Add lines 15 and 16)

Figure 3—**Schedule F of Form T (Timber)**



Form T (Timber) (Rev. 1-87) Page 4

Schedule E **Reforestation and Timber Stand Improvement** *(Continued)*

Account, block, tract, or area	Kind of activity (burning, chopping, spraying, planting, seeding, thinning, pruning, fertilizing, etc.)	Number of acres treated	Total expenditures
Total			

Schedule F **Capital Returnable Through Depletion**

In items 27 through 42, give separately the data for each timber account, covering any changes that have taken place during the tax year. Attach as many additional pages of this form as you need. If you deplete on the block basis, combine new purchases with the opening balances and use the average depletion rate shown on item 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in board feet or other log scale name the log rule used.

	Quantity in board feet, log scale, or other unit [1] (1)	Cost or other basis (2)
27. Title of account (name of block or tract) ▶		
28. Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year	1,000 CORDS	19,995
29. Increase or decrease of quantity of timber required by way of correction[2]		▨
30. a Addition for growth (Period covered ▶ 2 years)	200	▨
b Transfers from premerchantable timber account	80	1,386
c Transfers from deferred reforestation account		
31. Timber acquired during year		
32. Addition to capital during year[3]	▨	
33. Total at end of year, before depletion (add lines 28 through 32, in each column)	1,280	21,381
34. Unit rate returnable through depletion, or basis of sales or losses (line 33, column 2, divided by line 33, column 1)	▨	
35. Quantity of timber cut during year		▨
36. Depletion sustained (line 34 multiplied by line 35)	▨	
37. Quantity of timber sold or otherwise disposed of during year		▨
38. Allowable as basis of sale (line 34 multiplied by line 37)	▨	
39. Quantity of timber lost by fire or other cause during year		▨
40. Allowable basis of loss (line 34 multiplied by line 39)	▨	
41. Total reductions during year:	▨	▨
a Add line 35, column 1; line 37, column 1; and line 39, column 1	0	▨
b Add line 36, column 2; line 38, column 2; and line 40, column 2	▨	0
42. Net quantity and value at end of year (line 33, column 1 less line 41a, column 1; and line 33, column 2 less line 41b, column 2)	1,280	21,381

[1] If M board feet log scale is not the unit used, state what unit you used and explain it.

[2] Adjust the quantity in M feet, log scale, or other unit remaining at the end of the year for changes in reinventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, state clearly the basis for it.

[3] Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions in the return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

43. Quantity of timber cut that was sold as logs or other rough products	

44. Did you elect in your income tax return to report gain or loss from the cutting of timber in accordance with section 631(a) of the Internal Revenue Code? ☐ Yes ☐ No

If "Yes," furnish the information asked for in items 45 through 51.

45. Gain or loss as reported in your return. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis.

46. Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.

If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown in item 34, after adjustment.

planted in shelterbelts and windbreaks, and of trees planted primarily for nut production, also do not qualify.

Reforestation expenditures eligible for the amortization and credit do not include those reimbursed under a public cost-share program unless the reimbursed amount is included in taxable income. If the cost-share payment is reported as income, the total reforestation cost (including the cost-share payment), subject to the $10,000 limitation, qualifies for amortization and the tax credit.

Amortization

To make the election to amortize reforestation expenditures, you should attach to your income tax return Form 4562 and enter the required information and the deduction on part II, which concerns amortization. Also attach to that form, on a plain sheet of paper, a statement giving the amount of the expenditure, the nature of the expenditure, the date incurred, the type of timber being grown, and the purpose for which the timber is being grown. A separate statement must be included for each property for which reforestation expenditures are being amortized.

A half-year convention applies to amortization deductions. This means that only 1/14th of the eligible cost can be deducted the first year. One-seventh is deducted in each of years 2 through 7, and the remaining 1/14th in the eighth tax year.

Reforestation amortization constitutes a deduction from gross income under Code Section 62 (a)(11). Therefore the deduction can be shown by investors on the line for adjustments to income on the front page of Form 1040 by writing "reforestation" and the amount on that line. This amount is included in total adjustments to income. It is not necessary to itemize deductions. For those whose timber holdings are treated as a business (see page 9), the amortization deduction is taken on the "Other Expenses" line of Schedule C. For farmers, it is taken on the "Other Expenses" line of Schedule F. If you plant trees in more than one year you must maintain a separate amortization schedule for each year. Amortization must be elected on a timely filed return, including extensions, for the tax year in which the expenditure is made. The election cannot be made on an amended return. Once the election is made, however, missed amortization deductions may be taken on amended returns.

The amortizable basis of reforestation investments must be reduced by 50 percent of the investment tax credit taken. Thus, if the 10 percent tax credit is taken, only 95 percent of the eligible reforestation expenditure (a maximum of $9,500 per year) may be amortized.

If the trees are disposed of within 10 years, all of the amortization deductions claimed are subject to recapture by the IRS as ordinary income (to the extent of gain). There is no recapture, however, if the property is disposed of by gift, and generally recapture may not occur with respect to transfer at death, like-kind exchange, involuntary conversion, and certain tax-free transfers such as a transfer to a corporation you control.

Credit

The investment tax credit is taken on IRS Form 3468 in the section for nonrecovery property. If the trees are disposed of before 7 years, part or all of the credit is subject to recapture. All of the credit that was used to offset taxes is recaptured if the trees are disposed of in the first two full years after planting, 66.6 percent if within the third or fourth years, 33.3 percent if within the fifth or sixth year, and zero thereafter. Reforested stands are nonrecovery property. For additional information, see the instructions for Form 4255, "Recapture of Investment Credit." Example 3 shows how to claim the reforestation amortization and credit.

Example 3

Reforestation amortization and credit: Assume you reforested 120 acres during the tax year at a cost of $100 per acre, resulting in a total cost of $12,000. You receive no cost share payments.

When you file your income tax return for that tax year, you can take the tax credit on $10,000 of the reforestation expense and amortize $9,500 of it—the maximum amount of expenditure that qualifies in any one year. The remaining $2,000 is capitalized to the plantation sub-account.

The amortization would be elected as explained earlier. The amount amortized is $9,500—the $10,000 allowable reforestation expense less half of the $1,000 tax credit. Under this option, $679 (1/14th of the $9,500 allowable cost) is amortized in the first year. During each of the next six years $1,357 or 1/7th of the cost would be deducted, and the remaining $679 would be deducted in the eighth year. The investment tax credit of $1,000 is claimed on Form 3468.

Depreciation and the Section 179 Deduction

Timber producers often have large investments in machinery and equipment, and in land improvements such as bridges, fences, and buildings. The Internal Revenue Code allows you to take annual depreciation deductions on such property that is used in a business or held for the production of income; has a determinable useful life; and wears out, decays, gets used up, becomes obsolete, or loses value from natural causes. This section briefly explains changes made by the 1986 Tax Reform Act in the way depreciation is calculated. The basic rules are summarized to give an overview to timber owners and operators for tax planning purposes. The fine points and exceptions to the rules are omitted because of space limitations. You should consult IRS publications or your accountant for additional information on specific problems.

Section 179 Deduction

You may be able to deduct immediately as an expense up to $10,000 per year of the cost of qualifying depreciable property associated with or used in your timber operation if the operation qualifies as an active trade or business. This option is called the Section 179 deduction. You must elect to take the deduction on the first income tax return for the tax year in which the property is placed in service (whether or not the return is timely) or on an amended return filed within the time prescribed by law (including extensions) for filing the return for such tax year. Otherwise, the Section 179 election cannot be made on an amended return. If you elect the deduction, you must specify the part of the cost of each item you elect to deduct. The amount of the Section 179 deduction is subtracted from the basis of the property concerned before computing depreciation. You report the Section 179 deduction on Form 4562.

The $10,000 deduction is reduced one dollar for each dollar of investment during the tax year in question in Section 179 property over $200,000. Thus, if you place $208,000 of qualified property in service in a particular tax year, only $2,000 qualifies for the deduction. The deduction is also limited to the amount of taxable income (computed without subtracting the Section 179 deduction) attributable to your active conduct of trades or businesses. Depreciable investment property or property held for personal use does not qualify. The amount of eligible cost that is not deductible in one tax year because of insufficient active trade or business income may be carried forward to the next tax year (see example 4).

Example 4
Section 179 deduction: Assume you invest $7,000 in a used truck and $20,000 in a used tractor, both for your timber business. You have $9,000 of taxable active trade or business income for the tax year in question. You may elect a Section 179 deduction on Form 4562 for the $7,000 cost of the truck and you may also deduct an additional $2,000 on the tractor (or you could elect to deduct $9,000 on the tractor). Your total deduction is limited to the $9,000 of active trade or business income. The $1,000 difference between the $9,000 limit and the $10,000 allowable deduction may be carried forward to the next tax year.

The net benefit from the Section 179 deduction must be recaptured if the property in question is not used in an active trade or business more than 50 percent of the time in any tax year before the property's recovery (depreciation) period expires. Recapture of the Section 179 deduction is reported on Form 4797.

Depreciation

You, as a forest owner, may depreciate most property used on your woodland if you hold your woodland as either a business or as an investment. Land is never depreciable, but certain improvements to land such as fences, temporary roads, bridges and buildings are depreciable. To claim depreciation, you use the Modified Accelerated Cost Recovery System (MACRS) established by the 1986 Tax Reform Act for most tangible property placed in service after 1986. You cannot change to MACRS for property placed in service prior to 1987 that is being depreciated under another method such as the Accelerated Cost Recovery System (ACRS). Under MACRS, property is assigned a class life that determines the depreciation recovery period. The recovery periods for property under the general depreciation system are 3, 5, 7, 10, 15, and 20 years. For residential rental property, the recovery period is 27.5 years, and for nonresidential real property, 31.5 years. Table 4 shows the recovery periods for certain types of property typically associated with woodland.

Table 4—**Recovery Periods by Type of Property Under the General Depreciation System of Section 168 of the Internal Revenue Code**

MACRS[1] Recovery Period (Years)	Type of property
3	Over-the-road (semi) tractors
5	Automobiles and pickup trucks: includes logging machinery and equipment and road-building equipment used by logging and sawmill operators and pulp manufacturers for their own account.
7	Machinery and equipment such as farm tractors, planting machines, and fences. Before 1989, single purpose agricultural or horticultural structures; after 1988, single purpose structures are 10 year property. Also any property that does not have a class life and is not otherwise classified under Sections 168(e) (2) or (3).
10	Property with a class life of 16 years or more but less than 20 years.
15	Municipal wastewater plants (no timber-related property in this category).
20	Farm buildings (except single purpose agricultural or horticultural structures).
27.5	Residential rental property.
31.5	Nonresidential real property.

[1] Modified Accelerated Cost Recovery System.

Under MACRS, 3- , 5- , 7- , and 10-year property is depreciated in the beginning years using the 200 percent declining balance method, and 15 and 20 year property is depreciated in the beginning years using the 150 percent declining balance method. Depreciation is determined by the straight line method starting in the tax year when it maximizes the depreciation allowance. Under MACRS, you may also, in certain circumstances, calculate depreciation using the straight line method. You may elect to exclude certain timber-related property, such as temporary logging roads, from MACRS and depreciate it under the unit-of-production method or any method of depreciation not expressed in a term of years. With this method, a timber owner depreciates the property based on the number of units of timber harvested in a tax year as compared to the total number of units to be harvested over the life of the property. An example is a logging road constructed solely for use in harvesting specified timber and which on completion of harvesting will no longer be useful to the timber owner.

Section 168 of the Internal Revenue Code prescribes the applicable conventions (half-year, mid-quarter, and mid-month) to be used in computing depreciation deductions for the tax year in which MACRS property is placed in service and the tax year in which the property is disposed of or retired from service. Under the half-year convention, property (other than residential rental property and nonresidential real property) placed in service, disposed of, or retired at any time during the tax year is treated as being placed in service, disposed of, or retired on the mid-point of such year. Under this convention, a half-year of depreciation is allowable for the first tax year eligible property is placed in service regardless of when the property is actually placed in service during that year. If the aggregate basis of this depreciable property placed in service in the last 3 months of the tax year exceeds 40 percent of the aggregate bases of all such property placed in service during the tax year, however, the applicable convention for this property is the mid-quarter convention. Under the mid-quarter convention, all property placed in service, or disposed of, during any quarter of a tax year, is treated as being placed in service on the mid-point of the quarter. The allowable depreciation is a percentage of the depreciation for a full year; for property placed in service in the first quarter of the tax year, 87.5 percent; in the second quarter, 62.5 percent; in the third quarter, 37.5 percent; and in the fourth quarter, 12.5 percent.

The applicable convention for residential rental property and nonresidential real property is the mid-month convention. Under the mid-month convention, property placed in service, or disposed of, during any month of a tax year, is treated as being placed in service, or disposed of, on the mid-point of that month. Thus, regardless of when during the month a taxpayer places residential rental property or nonresidential real property in service, the property is deemed to be placed in service on the mid-point of the month.

Example 5

Depreciation:—A timberland owner spent $20,000 for a multipurpose machine shed which he placed in service in July 1987. He additionally purchased and placed in service in his business a $60,000 used over-the-road tractor in September and a $30,000 used rubber-tired skidder in October. No other depreciable property was placed in service by him in 1987. He also spent $12,000 in December to plant seedlings on 100 acres of his timberland. He is on a calendar year tax basis.

Since not more than 40 percent of the value of personal property purchased during the year (tractor and skidder) was placed in service in the last quarter of the tax year of this calendar-year taxpayer, the half-year convention applies as follows:

Section 179 deduction (he elects to deduct part of the skidder's cost):	$10,000
MACRS deduction on the over-the-road tractor (3 year property): $60,000 ÷ 3 years × 200% × 1/2 year	$20,000
MACRS deduction on the skidder (5 year property): ($30,000 − $10,000 Sec. 179) ÷ 5 years × 200% × 1/2 year	$ 4,000
MACRS deduction on the machine shed (31 1/2 year property): $20,000 ÷ 31.5 years × 5.5/12 years	$ 291
Reforestation amortization: $9,500 ($10,000 − 1/2 of tax credit) ÷ 7 years × 1/2 year	$ 679
Total deductions	$34,970
Reforestation tax credit: 10% × $10,000 limit	$ 1,000

If the over-the-road tractor had been placed in service after September, then more than 40 percent of the value of the personal property would have been placed in service in the last quarter of the tax year, and the mid-quarter convention would apply to the personal property as follows:

MACRS deduction on tractor $60,000 ÷ 3 years × 200% × 12.5%	$ 5,000
MACRS deduction on skidder $20,000 ÷ 5 years × 200% × 12.5%	$ 1,000
Total personal property deductions	$ 6,000
Total depreciation deductions on personal property (if more than 40% by value were placed in service in the last quarter of the tax year)	

This example illustrates the importance of planning purchases. By purchasing and placing the tractor in service in September before the last quarter, $34,000 of the cost of this equipment was deductible in 1987 compared to $16,000 if all of the personal property were purchased and placed in service in the last quarter of the tax year.

Operating Expenses and Carrying Charges

Timber owners commonly incur costs associated with the day-to-day management of their forest property. Such expenditures include, but are not limited to, fees paid to consulting foresters; travel expenses directly related to the income potential of the property; the costs of silvicultural activities such as prescribed burning and precommercial thinning; the expenses of fire, insect and disease protection; the costs of tools having a short useful life; salaries for hired labor; and professional fees. These types of expenditures are known as timber operating costs. Woodland owners also generally incur expenses for property taxes and perhaps for interest and insurance. Such costs, together with certain other expenses related to the development and operation of timber properties, are termed "carrying charges."

Operating costs and carrying charges that are considered to be "ordinary and necessary" expenses of managing, maintaining, and conserving forest land may be wholly or partially deducted (expensed) each year as incurred, even if the property is currently producing no income—provided that the timber growing activity is being engaged in for profit and the expenditures are directly related to the income potential of the property. A presumption that an activity is being carried on for profit applies if there has been net income from the property (profit) in at least 3 of the 5 consecutive years ending with the current year. If this test cannot be met, however, deductions are not automatically denied. Rather, all facts and circumstances of the situation are considered in determining whether or not a profit motive exists. The term "profit" includes appreciation in the value of assets. This principle is particularly relevant in the case of timber, which is unique property in that its appreciation in value—contrary to most other assets—is due primarily to physical growth over a long period of time. Although there is often no net income from forest properties for many years, the intent of most owners is to achieve an overall profit once the increase in timber value is realized.

As an alternative to currently deducting timber related expenditures, you may elect to capitalize them if you so choose. Strictly speaking, only carrying charges may be capitalized. Carrying charges are taxes, interest, and certain other expenses related to the development and operation of timber properties that may be treated as either deductible expenses or capital costs. As a practical matter, however, many other deductible timber-related costs are considered to be carrying charges. Capitalized carrying charges are added to the timber's basis and are recovered by offsetting gain realized upon the sale or cutting of timber, as discussed on page 23.

Although the regulations governing the capitalization of carrying charges do not specifically address timber-related costs, they do set forth general rules that are applicable to the capitalization of timber expenditures. They provide that in the case of "unimproved and unproductive real property," taxpayers may elect—on a year-to-year basis—to capitalize "annual taxes, interest on a mortgage, and other carrying charges." Unimproved real property is generally defined as land without buildings, structures, or any other improvements that contribute significantly to its value. Forest land is unproductive in any year in which no income is produced from its use—such as from hunting leases, timber sales, or sale of products cut from timber. You may not capitalize carrying charges—such as yield and severance taxes—incurred in any year your property is productive.

The regulations additionally provide with respect to real property "whether improved or unimproved, and whether productive or unproductive," that taxpayers may elect to capitalize necessary expenditures associated with development of the property up to the time the development is completed. Once made, however, the election to capitalize "development-related expenditures" continues in effect until development has been completed. Expenditures incurred for silvicultural treatments in established stands—such as noncommercial thinning and other timber stand improvement work—fall into this category. This means that such costs may be capitalized to the timber account if you do it consistently from year to year.

You elect to capitalize by filing with your original return for the year for which the election is to be effective a statement indicating the cost items you are capitalizing.

The Passive Loss Rules

The extent to which operating costs and carrying charges are currently deductible depends on how you are classified under the 1986 Tax Reform Act with respect to ownership and operation of your forest property. This legislation made a number of significant changes related to deductions that are set forth in what are called the "passive loss rules."

The passive loss rules govern the extent to which an operating loss from a particular activity for any given tax year can be offset against income from other sources. The passive loss rules apply to individuals, estates, trusts, and to two categories of corporations: "personal service corporations" (those whose principal activity is the performance of personal services which are substantially performed by employee-owners) and "closely held C corporations" (those that are subject to the corporate income tax and in which more than 50 percent of the value of the stock is owned by five or fewer individuals). Except for these two types of corporations, the passive loss rules do not apply to corporations generally. The passive loss rules also do not apply directly to partnerships and Subchapter S corporations since they are essentially "flow-through" entities that are not taxed in their own right. However, the rules do apply to deductions passed through from partnerships and Subchapter S corporations to individuals, estates, trusts, personal service corporations, and closely held C corporations.

If your timber ownership is subject to the passive loss rules, you must determine which of the following three classifications applies to you and your forest property. This determination must be made each tax year. The rules for deducting operating costs and carrying charges vary, depending on which of these categories your timber activity fits. The three categories are as follows:

(1) timber held as part of a trade or business in which you materially participate;

(2) timber held as part of a trade or business in which you do not materially participate (that is, a passive activity); and

(3) timber held for the production of income (that is, as an investment), but which is not part of a trade or business.

Timber Held as Part of a Trade or Business In Which the Taxpayer Materially Participates—In this situation all operating expenses and carrying charges related to the timber activity are fully deductible against income from any source each year as incurred. Credits arising from the timber activity (such as the reforestation tax credit discussed on page 17) can also be applied to taxes associated with income from any source. If your total deductions from your trade or business activities (including your forest property) exceed your gross income from all sources for the tax year, the excess will be a "net operating loss." This loss generally may be carried back to the 3 preceding tax years and, if still unused, then be carried forward to the next succeeding 15 tax years.

Material Participation—The law provides that to be "materially participating," a taxpayer must be involved in operations with respect to the property on a basis which is "regular, continuous, and substantial." According to temporary regulations issued by the Internal Revenue Service, you will be considered to be materially participating in the operation of your timber activity if you meet at least one of the following tests:

(1) you and your spouse participate in the activity for more than 500 hours during the tax year.

(2) you and your spouse's personal participation in the activity constitutes substantially all of the participation (including that of all other individuals) for the tax year.

(3) you and your spouse participate in the activity for more than 100 hours during the tax year and no other individual participates more.

(4) you and your spouse's aggregate participation in all of your "significant participation activities," including your timber activity, exceeds 500 hours during the tax year. An activity is a "significant participation activity" if it is a trade or business in which you participate for more than 100 hours during the tax year. Thus, you could qualify under this test even if another individual who co-owns forest property with you participates in its operation more than you do during the tax year in question.

(5) you and your spouse materially participated in the activity for any 5 of the preceding 10 tax years. For this purpose, material participation in pre-1987 tax years is counted: you must meet the 500 hour test to qualify in any of those years.

(6) if all the facts and circumstances of the situation indicated that you and your spouse participated in the activity on a regular, continuous and substantial basis during the tax year. The specific rules to be followed in applying this test have not been issued by the Internal Revenue Service at this writing, but will be the subject of future regulations. However, several general principles may currently be used as guides. The first is that your management of the timber activity isn't taken into account if a paid manager participates in its management or if your management services are exceeded by those performed by any other individual.

And second, if you don't participate in the timber activity for more than 100 hours during the tax year, you cannot satisfy the facts and circumstances test for the year.

Formal recordkeeping is not required to prove the number of hours you devote to operation of your timber activity. You are allowed to prove the number of hours by any reasonable means, including—but not limited to—appointment books, calendars, and narrative summaries.

Both you and your spouse will be treated as one taxpayer for purposes of determining whether the material participation requirement has been met. It does not matter whether your spouse owns an interest in the property or not, or whether you file joint or separate tax returns.

Reporting Expenses—If your timber operations are incidental to farming activities, list your deductible timber expenses together with your deductible farming expenses on Schedule F of Form 1040, "Farm Income and Expenses," on the line for "other" expenses. There are separate lines for tax and interest deductions. Your deductions should be individually listed.

If your timber operations are a separate business, or are incidental to a nonfarm business, report your timber deductions on Schedule C of Form 1040, "Profit or (Loss) from Business or Profession," on the line for "other" expenses. There are also separate lines on Schedule C for tax and interest deductions. Your deductions should be individually listed.

Timber Held As Part of a Trade or Business In Which You Do Not Materially Participate—The second category is timber held as part of a "trade or business" in which you do not materially participate in one of the ways discussed earlier. Under the passive loss rules, this type of forest ownership is classified as a "passive activity". C corporations (those subject to the corporate income tax) that are not classified as closely held or as personal service corporations can currently deduct operating costs and carrying charges associated with passive timber ownership from income from any source without limitation. Generally, deductions attributable to passively held forest properties and other passive activities by other categories of passive owners are allowed only to the extent of total income from all passive activities during the tax year. The exception to this rule is that closely held C corporations are permitted to offset deductions from passive activities against income from active businesses (but not against portfolio income, which includes such items as dividends and interest). Credits attributable to passive timber ownership (such as the reforestation tax credit discussed on page 17) may only be applied to offset taxes associated with income from passive activities.

If your deductions from a passive timber ownership (including depreciation and amortization deductions) exceed your passive income (from all sources) for the tax year, the excess may be carried forward and be used in future years when you either realize passive income or else dispose of the entire timber ownership that gave rise to the passive loss. Credits you are not able to use during a particular tax year may also be carried forward (but not back) for use in future years but may not be taken in the year that you dispose of your entire ownership interest.

If you acquired a passive timber ownership interest after October 22, 1986, the rules discussed above are fully effective. However, if your ownership interest was acquired on or before that date, a 5-year phase-in of the passive activity loss and credit limitations is provided. During the phase-in period, a limited percentage of passive activity losses and credits can be used to offset nonpassive income and taxes. The percentage of the passive activity loss allowed for each year of the phase-in period is as follows:

Tax year beginning in	Percentage allowed to offset nonpassive income and taxes
1987	65
1988	40
1989	20
1990	10
1991	0

For tax reporting, computation of allowable passive deductions for the tax year is calculated on Form 8582, "Passive Activity Loss Limitations". It is beyond the scope of this publication to describe in detail the use of this complex form. If your timber ownership is passive in nature, you may want to consult a professional tax advisor concerning the use of Form 8582.

Timber Held as an Investment—The third category is timber held as an investment, rather than as part of a trade or business. The distinction between a "trade or business" and an "investment" is not always an easy one to make. In general, however, an investment is an undertaking entered into or engaged in with a view to realizing a profit—but which does not involve the same regularity or frequency of activity that a trade or business would require. As under prior law, corporations in the investment category can fully deduct operating costs and carrying charges against income from any source. However, as described next, the deductibility of these expenditures by noncorporate investors is generally more limited.

Management Costs—Both corporate and noncorporate timber owners may generally deduct management costs relating to timber held as an investment against income from any source. Management costs, as used here, include all operating costs and carrying charges except property taxes and other deductible taxes, and interest. However, for noncorporate taxpayers, such expenditures are classified as "miscellaneous itemized deductions." This means that they can be deducted only to the extent that, when aggregated with all of your other "miscellaneous itemized deductions," the total exceeds 2 percent of your adjusted gross income. The proportion of such deductions that falls below the 2-percent floor is permanently lost. Other types of "miscellaneous itemized deductions" that you may incur include—but are not limited to—costs of tax return preparation, safe-deposit box rental, financial journal subscriptions, and investment advice. Timber management costs in this category may also be capitalized as carrying charges as discussed on page 20, if you prefer. However, the same expenditure cannot be counted toward the 2-percent floor on "miscellaneous itemized deductions" and also be capitalized.

Taxes—Property and other deductible taxes attributable to your timber held as an investment are deductible in full each year against income from any source by both corporate and noncorporate taxpayers. Tax deductions by noncorporate timber investors are not "miscellaneous itemized deductions" and therefore are not subject to the 2-percent floor for such deductions. If you prefer, you may elect to capitalize property taxes and recover them upon sale of the timber rather than deduct them in the year paid. Severance and yield taxes may not be capitalized; however, they may be currently deducted.

Interest—Corporate taxpayers may deduct unlimited timber investment interest expense against income from any source. If you are a noncorporate timber investor, however, you may deduct—through the 1990 tax year—interest expense (from both timber and nontimber sources) only up to net investment income (from all sources) for the tax year plus a specified percentage of the excess, but not more than $10,000 ($5,000 if married and filing a separate return) times the specified percentage. For 1988 the allowable percentage is 40, for 1989 it is 20, and for 1990 it is 10. After 1990, no deduction is allowable on any investment interest in excess of net investment income. Net investment income is your investment income less expenses other than interest expense that are directly connected with production of the investment income (See IRS Publication 550, "Investment Income and Expenses.") Example 6 explains how much investment interest expense can be deducted.

Example 6

Deduction of Investment interest expenses: Suppose you incur $3,000 of investment interest expense in 1988 but only have $2,000 of net investment income. You may not deduct the full $3,000 of interest paid. Rather, you may deduct $2,000 (amount of net investment income) plus 40 percent of the excess $1,000, or $400, for a total deduction of $2,400. Any excess of investment interest expense over net investment income that cannot be deducted in a particular tax year (such as the $600 in this example) may be carried forward and be eligible for deduction in any later year in which net investment income—from any investment source—is realized.

As discussed above, you may elect to capitalize all or part of the interest paid, instead of deducting it or carrying it forward, and thus use it to offset income realized from sale of the timber.

Reporting Expenses—Your deductible investment expenses are listed on Schedule A of Form 1040 on the appropriate line for each type of deduction. This is possible only if you itemize deductions for the year. If in any tax year you do not itemize deductions, or alternatively do not elect to capitalize these expenses, the costs are lost for tax purposes and you will not be able to recover them.

Chapter VI. Income Considerations

Timber Sale Receipts

When you dispose of standing timber you must determine the type, as well as the amount, of gain or loss for federal income tax purposes. The type of gain or loss will depend on how long you have owned the timber, your purpose for owning it, how you dispose of it, and what kind of timber-related activities you normally engage in.

Determining the Amount of Gain or Loss

Net gain or loss from the disposition of timber is generally determined in the same way as for most other assets. The total amount received is reduced by any expenses directly related to the transaction and by the adjusted basis of the timber. A special rule applies to certain timber cut by the owner, as explained later on page 28. When timber acquired as a single unit is disposed of in more than one transaction over a period of years as the trees mature, special procedures must be used to determine the deductible basis of the timber disposed of at any one time. The procedures and rules for doing this were not changed by the 1986 Tax Reform Act.

Adjusted Basis—As discussed on page 11, once you have established the original basis of your timber you must adjust it as needed. For large properties, adjustments may have to be made in the timber accounts from year to year to keep current the dollar amounts and volumes shown in the accounts. These annual adjustments should reflect additional timber acquired, timber cut or sold since the last adjustment, timber losses claimed on your tax return, and capitalized costs as called for by Schedule F of Form T. They should also include transfers during the year from young growth or plantation subaccounts to merchantable timber subaccounts, and the amount of growth since the last adjustment. In addition, the number of units shown in a timber account should be changed to correct inaccuracies or to reflect changed standards of utilization. You should additionally adjust accounts if you change to a different log rule or other unit of measure. At the end of any year in which a disposition occurs, but before basis recovery is computed, each timber account should reflect how much merchantable timber in that account was available for cutting.

If you own a small tract, and sell or cut timber infrequently, you may need to make adjustments—including those reflecting growth—only at times of disposal. In the case of a timber sale, the growth determination can easily be made by reestimating the total volume of merchantable timber present on the tract at the same time that the trees to be cut are marked or otherwise selected. Adjusting a timber account is discussed and illustrated in detail in chapter X, Forest Records.

How to Recover Your Basis—Once adjusted basis has been calculated, it is necessary to determine the depletion unit. This is done by dividing the adjusted basis shown in the timber account by the total volume of timber in the account. The depletion unit is usually expressed in dollars per unit of measure, such as thousand board feet or cords. However, the unit for Christmas tree plantations may be the individual tree. A depletion unit should be determined for each timber account. Although the depletion unit is always determined in the same way, how you use it to recover your basis in timber depends on whether you disposed of standing timber or, alternatively, cut it yourself.

Recovery of Basis—Disposal of Standing Timber—Standing timber may be disposed of by either a lump-sum sale or under a pay-as-cut contract, as discussed on page 28. With either method, basis is recovered by reducing any proceeds received by the adjusted basis of the timber disposed of. Example 7 illustrates use of the depletion unit to recover basis and determine net gain from the disposal of standing timber.

Example 7
Disposal of Standing Timber: In 1988 you sold 1,000 cords of the timber available on your 150 acre tract. The contract price was $22,000 payable in cash on the effective date of the contract. You had not sold, cut, or otherwise disposed of any timber in prior years. You contracted with a consulting forester to cruise, mark and sell the mature trees. The consultant charged 10 percent of the gross sale proceeds or $2,200 for his services.

You determine your deductible basis for the timber sold by multiplying the depletion unit by the number of units sold. The adjusted dollar basis of your timber account available for depletion as of the end of 1988 was $32,408. The adjusted volume at the end of 1988, after adding the growth that occurred, was 2,320 cords. The depletion unit was thus $13.97 per cord, obtained by dividing the adjusted dollar basis by the adjusted volume. The deductible basis for the sale was therefore $13,970—determined by multiplying the $13.97 depletion unit by the number of units sold, or 1,000 cords. The allowable deductible basis of the timber sold is reported on Schedule F of Form T as shown in figure 4, and the profit from the sale is reported on Schedule C of Form T as shown in figure 5 (the figure shows only part of schedule C).

Recovery of Basis—Cutting of Standing Timber—Instead of selling standing timber that is cut by the purchaser, you may cut your timber yourself or have someone cut it for you. Your adjusted basis may then be recovered by subtracting it from the proceeds received from sale of the logs,

Figure 4—**Schedule F (Form T)**
Capital Returnable Through Depletion

Line number on Form T	Quantity in board feet, log scale, or other unit (1)	Cost or other basis (2)
28. Estimated quantity. . [at end of 1987]	2,110 cords	$32,408
30a. Addition for growth (1 year)	210	
33. Total at end of 1988, before depletion	2,320	$32,408
34. Unit rate	—	13.97
37. Quantity of timber sold	1,000	—
38. Allowable as basis of sale	—	13,970
41. Total reductions during year: (a) Sum of lines 35, 37, and 39	1,000	
(b) Sum of lines 36, 38, and 40	—	13,970
42. Net quantity and value at end of year (1988)	1,320 cords	$18,438

or from sale of products you produce from them. This type of recovery is termed timber depletion. Example 8 illustrates the recovery of basis when you cut your own timber.

You cannot claim a depletion allowance for timber cut for personal use, such as firewood for your home, and you do not adjust the dollar amount in the account when you do this type of cutting. However, if you cut very much timber for personal use, you may need to adjust the quantity shown in the account to reflect the decrease in timber that is available for commercial cutting or sale.

Example 8

Recovery of basis when standing timber is cut: You cut 500 cords of your timber from the 150-acre tract. The cutting was completed in 1989 at a cost of $7,520 for fuel and depreciation on equipment. However, you could sell only 300 cords by the end of your 1989 tax year. You received $40 per cord for the wood sold. Your depletion unit for the timber cut was $12.89 per cord, determined as shown on Schedule F of Form T (fig. 6), where the values are carried forward from example 7, page 23.

You report the profit on the sale of the wood on Schedule C of your Form 1040, as follows:

1989 Income on sale of wood	
Proceeds from wood sales—(300 cords × $40 per cord)	$12,000
Less:	
Depletion allowance—(300 cords × $12.89 per cord)	$ 3,867
Logging expenses—(300 cords × $15.04 per cord)	$ 4,512
Total expenses	$ 8,379
Profit on wood sales	$ 3,621

If you had elected and qualified under the provisions of Section 631(a), such an election would qualify a portion of the income for capital gain treatment, discussed on page 28.

The wood not sold in 1989 is entered into a wood inventory account, as follows:

Closing 1989—opening 1990 wood inventory account	
Volume (cords)	200
Cost: Depletion allowance—(200 cords × $12.89 per cord)	$ 2,578
Logging expenses—(200 cords × $15.04 per cord)	$ 3,008
Total	$ 5,586

Determining the Kind of Gain or Loss

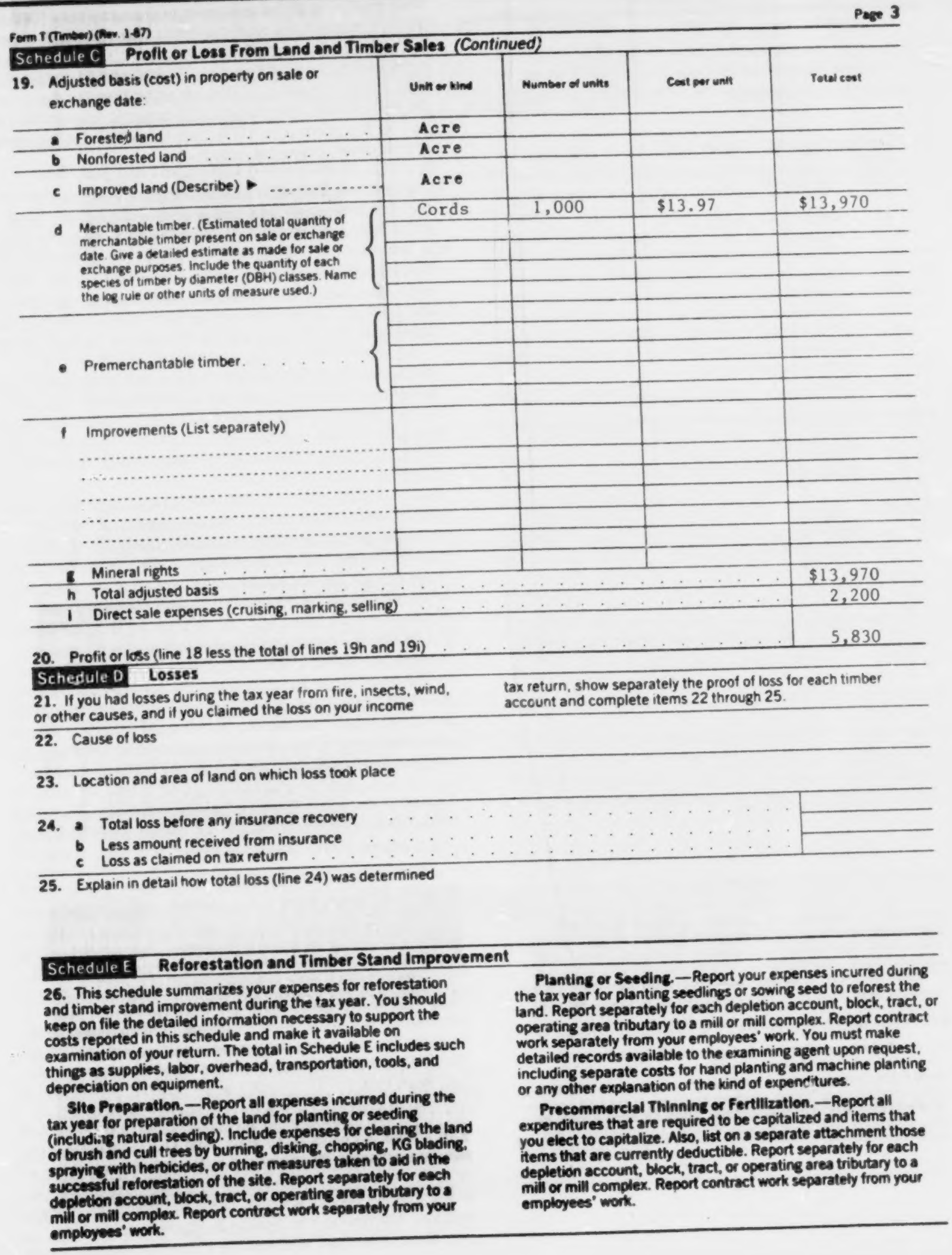
Standing timber may be treated for income tax purposes as either a capital asset or a noncapital (ordinary) asset. This distinction is critical in determining whether a timber owner's gain or loss is considered "ordinary" or "capital" in nature and in determining how timber gains and losses are reported.

For 1986, noncorporate taxpayers paid Federal income tax on only 40 percent of their net capital gains (that is, the excess of net long-term capital gains over net short-term capital losses). Since the maximum marginal non-corporate Federal income tax was 50 percent, this meant that the maximum effective tax rate on net capital gains was only 20 percent (40 percent of net capital gain included in income taxed at a 50-percent rate), as compared with a maximum rate of 50 percent on ordinary income. For corporations, the maximum tax rate was 46 percent on ordinary income, but only 28 percent on net capital gains. Thus, both noncorporate and corporate taxpayers benefited if the proceeds of their timber sales qualified as long-term capital gains rather than as ordinary income.

In enacting the 1986 Tax Reform Act, Congress lowered the maximum tax rates on ordinary income and repealed the differential between the respective rates at which ordinary income and net capital gains are taxed. Beginning in 1988, the rate differential between ordinary income and net capital gains was entirely eliminated for all taxpayers. Tables 5 and 6 reflect how noncorporate and corporate taxpayers are currently taxed.

In 1988 and later years, a 5-percent "surtax" (i.e., a 33-percent rate) applies to noncorporate taxable income within certain ranges. It is intended to phase out the benefits of the 15-percent rate and the deduction for personal exemptions for higher income taxpayers. The 33-percent rate takes effect at the levels of taxable income necessary to phase out the benefits of the 15-percent rate (i.e., $149,250, $89,560, and $26,000 respectively, for married taxpayers filing jointly, single taxpayers and estates and trusts). It is then applied to any taxable income above those levels until the benefits of the personal exemptions claimed are phased out (i.e., for 1988, $10,920, and for 1989, $11,200 of taxable income for every personal exemption claimed). Above this level of taxable income at which the benefits of personal exemptions are phased out, the tax

Figure 5—Schedule C of Form T (Timber)



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Form T (Timber) (Rev. 1-87)

Schedule C **Profit or Loss From Land and Timber Sales** *(Continued)*

19. Adjusted basis (cost) in property on sale or exchange date:	Unit or kind	Number of units	Cost per unit	Total cost
a Forested land	Acre			
b Nonforested land	Acre			
c Improved land (Describe) ▶	Acre			
d Merchantable timber. (Estimated total quantity of merchantable timber present on sale or exchange date. Give a detailed estimate as made for sale or exchange purposes. Include the quantity of each species of timber by diameter (DBH) classes. Name the log rule or other units of measure used.)	Cords	1,000	$13.97	$13,970
e Premerchantable timber				
f Improvements (List separately)				
g Mineral rights				$13,970
h Total adjusted basis				2,200
i Direct sale expenses (cruising, marking, selling)				
20. Profit or loss (line 18 less the total of lines 19h and 19i)				5,830

Schedule D **Losses**

21. If you had losses during the tax year from fire, insects, wind, or other causes, and if you claimed the loss on your income tax return, show separately the proof of loss for each timber account and complete items 22 through 25.

22. Cause of loss

23. Location and area of land on which loss took place

24. a Total loss before any insurance recovery	
b Less amount received from insurance	
c Loss as claimed on tax return	

25. Explain in detail how total loss (line 24) was determined

Schedule E **Reforestation and Timber Stand Improvement**

26. This schedule summarizes your expenses for reforestation and timber stand improvement during the tax year. You should keep on file the detailed information necessary to support the costs reported in this schedule and make it available on examination of your return. The total in Schedule E includes such things as supplies, labor, overhead, transportation, tools, and depreciation on equipment.

Site Preparation.—Report all expenses incurred during the tax year for preparation of the land for planting or seeding (including natural seeding). Include expenses for clearing the land of brush and cull trees by burning, disking, chopping, KG blading, spraying with herbicides, or other measures taken to aid in the successful reforestation of the site. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

Planting or Seeding.—Report your expenses incurred during the tax year for planting seedlings or sowing seed to reforest the land. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work. You must make detailed records available to the examining agent upon request, including separate costs for hand planting and machine planting or any other explanation of the kind of expenditures.

Precommercial Thinning or Fertilization.—Report all expenditures that are required to be capitalized and items that you elect to capitalize. Also, list on a separate attachment those items that are currently deductible. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

Figure 6—**Schedule F (Form T)**
Capital Returnable Through Depletion

Line number, on Form T	Quantity in board feet, log scale, or other unit (1)	Cost or other basis (2)
28. Estimated quantity. . .[at end of 1988]	1,320 cords	$18,438
30a. Addition for growth (1 year)	110	—
33. Total at end of year (1989), before depletion	1,430	$18,438
34. Unit rate	—	12.89
35. Quantity cut	500	—
36. Depletion sustained	—	6,445
41. Total reductions during year:		
(a) Sum of lines 35, 37, and 39	500	—
(b) Sum of lines 36, 38, and 40	—	6,445
42. Net quantity and value at end of year (1989)	930 cords	$11,993

Table 5—**How Noncorporate Taxpayers are Currently Taxed**[1]

Married taxpayers filing joint return	Single taxpayer	Estates and trusts	Net capital gains	Ordinary income
Taxable income			Maximum Marginal Tax Rate, Percent	
0-$29,750	0-$17,850	0-$5,000	15	15
$29,750-71,900	$17,851-43,150	$5,001-13,000	28	28
$71,900 +	$43,151 +	$13,001 +	33[2]	33[2]

[1] Two other categories of noncorporate taxpayers are not shown in the table—married taxpayers filing separate returns and heads of household.

[2] This rate is the result of a 5-percent "surtax" applied to taxable income within certain ranges as discussed in the text.

Table 6—**How Corporate Taxpayers Generally are Currently Taxed**

Taxable income	Maximum marginal tax rate, percent	
	Net capital gains	Ordinary income
0-$50,000	15	15
$50,001-75,000	25	25
$75,001-100,000	34	34
$100,001-$355,000	39[1]	39
$335,001 +	34	34

[1] As reflected by the table, a 5 percent "surtax" applies to income within these ranges.

rate returns to 28 percent. As an example, if the income level taxable at 28 percent were unchanged from 1988 to 1989, a married couple filing jointly and claiming two personal exemptions would be taxed at the 33-percent rate on 1989 taxable income between $71,900 and $171,650. Taxable income above $171,650 would be taxed at the 28-percent rate. The 28-percent bracket is indexed for inflation for tax years after 1988; thus the actual 1989 ranges should differ somewhat from these.

Capital Gain Status Is Still Important—Even though the rate differential between ordinary income and net capital gains has been eliminated, capital gains continue to exist as a concept in the tax law. There is still a recognized difference between ordinary income and capital gains. Sections 1221, 1231, 631(a) and 631(b) of the Internal Revenue Code, which are relevant in qualifying timber proceeds as capital gains, remain as part of the Internal Revenue Code.

Although net capital gains are now taxed at the same rates as ordinary income, it may still be important for you to be certain that income from the sale or cutting of timber qualifies to the extent possible as a long-term capital gain. For example, capital losses may be used to offset only $3,000 of ordinary income per year, but there is no limit on using such losses to offset capital gains. Thus, if you have large capital losses from any source, you may be able to deduct a greater proportion of those losses during any year in which you have timber capital gains. Also, if you are a sole proprietor or partner whose timber holdings are considered to be a business (see page 9), you are subject to self-employment tax (see page 39) on ordinary income from the business. If your timber proceeds qualify for and are reported as capital gains, however, they will not be subject to this tax. This is an important consideration, particularly for those timber owners who are retired or semi-retired and who have little or no income from wages or salary. The rate of self-employment tax for 1988 and 1989 is 15.02 percent minus a 2 percent credit, for a net rate of 13.02 percent.

Capital Gains From Timber Transactions—Whether your timber gains and losses qualify for capital gains treatment or not depends on these three factors:

- **Primary Purpose for Holding the Timber:** Standing timber is a capital asset if it is neither used in a trade or business nor held primarily for sale to customers in the ordinary course of a trade or business. Gain on the outright (lump-sum) sale or exchange of such timber, if owned for more than the required holding period (see below), is a long-term capital gain. Although timber used in a trade or business is not a capital asset, its outright sale may nevertheless also result in a long-term capital gain under Section 1231 of the Internal Revenue Code if the holding period has been met.
- **How the Timber Is Disposed Of:** You may dispose of your timber in one of three ways, namely (1) by lump-sum sale or exchange, (2) under a pay-as-cut contract where you retain an economic interest as provided by Section 631(b) of the Internal Revenue Code, or (3) by cutting the timber yourself; converting it to salable products such as logs, pulpwood or lumber; and making a specific election under

Section 631(a) of the Code. If your timber is held primarily for sale to customers in the ordinary course of business, generally only the last two methods will provide capital gains. The complexity of tax treatment of revenues and expenditures associated with timber leases/long-term cutting contracts is beyond the scope of this publication. For information on the subject, consult Revenue Rulings 62-81, 62-82, 75-59 and 78-267. All are summarized in Appendix I.

- **How Long the Timber Has Been Held:** To qualify for long-term capital gains, you must have held purchased timber for more than one year prior to cutting, unless it was acquired after June 22, 1984 and before January 1, 1988. Purchased timber acquired during that time need only have been held for more than 6 months, but when cutting under a Section 631(a) election the timber (or the contract right to cut the timber) also must have been held on the first day of your tax year. The holding period must also be met when disposing of timber acquired by gift. However, both the donor's and donee's time of ownership may be counted; thus the holding period with respect to the donee may be entirely met before the gift is even made. For inherited timber, there is no holding period required in order to qualify for long term capital gain status.

Sale of Standing Timber for a Lump Sum

A sale for a lump sum is the outright sale (usually by means of a timber deed or sale contract) of standing timber for a fixed total amount agreed upon in advance. The sale may cover all timber on a specified tract; or only certain species, diameter classes, or individually marked trees on the tract.

Capital gains treatment will apply if the timber is a capital asset in the hands of the seller. Timber will be a capital asset in your hands if it is not held primarily for sale to customers in the ordinary course of a trade or business and is not property that is used in a trade or business. This means that timber is a capital asset if you are holding it primarily for personal use or as an investment, as discussed in the section "Types of Forest Ownership and Operation," page 9. Whether timber is held primarily for sale in the ordinary course of a trade or business is not always easy to determine. There is no generally applicable definition of "trade or business" in the Internal Revenue Code or in the Income Tax Regulations. There is also no broadly applicable judicial definition of the phrase. Thus the question can only be answered by weighing all the facts and circumstances of each particular situation. Although no single factor is determinative, the following factors are important:

(1) the purpose for acquiring and holding the timber, whether for sale or investment,

(2) the number, continuity, and frequency of timber sales, as opposed to isolated transactions,

(3) the extent to which you solicit or promote timber sales, as opposed to merely letting prospective purchasers approach you, and

(4) any facts that indicate that timber transactions are part of your occupation or contribute substantially to your livelihood. In general, if you only make an occasional timber sale that is unrelated to any trade or business in which you are engaged, the timber will qualify as a capital asset and the proceeds will thus qualify for capital gains treatment.

If you intend to sell standing timber, and are in doubt about its capital asset status, you should consider entering into a contract for disposal with an "economic interest retained" (see page 28).

Capital gains and losses are reported differently from ordinary income on your tax return. The rules are discussed in Publication 544, "Sales and Other Dispositions of Assets". To roport lump-sum timber sales whose proceeds qualify as capital gains, Schedule D of Form 1040 should be used. Non-timber capital gains transactions are also reported on Schedule D. If the long-term gain holding period has been met, the timber transaction is entered in Part II. If the holding period has not been met, the information is entered in Part I (short term capital gains and losses). The use of Schedule D is shown in the following example.

Example 9

Sale of standing timber: You sold 60 thousand board feet (MBF) of standing timber in a lump-sum sale on August 15, 1988. The contract price was $9,000. The timber was located on land purchased on March 1, 1967, as part of a farm. Your adjusted basis in the timber sold was $1,413, computed according to the procedures discussed in the section "Determining the Amount of Gain or Loss", page 23, and as illustrated in Chapter X, "Forest Records." The State service forester marked and tallied the trees sold and estimated the volume. This service was provided free. However, you paid $250 in legal fees to have the contract checked and to close the sale. You are primarily engaged in crop and livestock production on the farm and sell timber infrequently. The timber should be considered to be a capital asset in your hands and the proceeds therefore reported on Schedule D. The sale resulted in a long-term capital gain of $7,337 (sale proceeds of $9,000 less $250 for sale expenses and less the allowable basis of $1,413). This transaction is entered in Part II of Schedule D as shown in figure 7.

If your sale involves installment payments extending beyond the year of sale, see the discussion of installment sales on page 32.

Figure 7—**Schedule D (Form 1040) 1987—Capital Gains and Losses**

(a) description	(b) date	(c) date sold	(d) price	(e) cost	(f) loss	(g) gain
Line 9c						
60 MBF Timber	3/1/67	8/15/87	$8,750	$1,413	---	$7,337

Gains and losses from lump-sum sales of standing timber that do not qualify for capital gains treatment because the timber was held primarily for sale to customers in the ordinary course of business are ordinary gains and losses. These have to be reported on a business schedule, either Schedule C or Schedule F. Include an attachment on a plain sheet of paper giving the details of the sale, and showing the calculation of the deductible basis, if any.

Disposal of Standing Timber With an Economic Interest Retained (Section 631(b))

Timber cut under a contract that requires payment at a specified rate for each unit of timber actually cut and measured, rather than as a lump-sum amount of money agreed on in advance, is a disposal with an economic interest retained rather than a sale of timber. This type of transaction is often called a "pay-as-cut" contract. It obligates the purchaser to cut the designated trees and purchase them at the unit price designated in the contract.

The term "economic interest" arises from the fact that the owner of timber has an investment in the timber and secures income from the cutting of the timber, to which the owner must look for a return of the investment. The seller usually retains legal title to the timber until it is cut and thus bears the risk of any damage to or loss of the standing timber. Advance payments are permitted under a Section 631(b) contract. However, in such a case, the contract has to clearly stipulate that, upon completion of the cutting, adjustments must be made, as required, in order that the total amount paid is determined by the volume of timber actually cut multiplied by the specified unit price.

Scaling the cut timber is the usual but not the only acceptable method of measurement. The volume can also be determined by cruising the standing timber subject to the contract. The amount actually disposed of is then the cruised volume before cutting minus the cruised volume of any contract timber that was not cut (see the digest of Revenue Ruling 78-104, page 64).

Two important advantages are offered by Section 631(b) contracts. First, the gain realized is treated as a capital gain regardless of whether the timber was held primarily for sale as part of a business—even if you are a dealer in timber.

The second advantage is that timber qualifying under Section 631(b) is Section 1231 property, which means that you are entitled to capital gains treatment when aggregate Section 1231 gains exceed aggregate losses from the disposition of such property. Section 1231 gains and losses are reported on Form 4797 and totaled. If a net gain results, it is treated as a net long-term capital gain and is transferred to Part II of Schedule D. There it is combined with any other long-term capital gains and losses for the year. If the summation of Section 1231 gains and losses results in a net loss, however, it is treated as an ordinary loss. This means that it is fully deductible from ordinary income in the current year. The net loss is transferred to Part II of Form 4797 where it is combined with any other ordinary gains and losses for the year (see IRS Publication 544, "Sales and Other Dispositions of Assets").

Three provisions of Section 631(b) will be discussed in more detail. **The first provision** concerns the definition of "owner" for purposes of qualifying under Section 631(b). The term is broadly defined to include any person or legal entity, including sublessors and holders of contracts to cut timber. To qualify as an owner, you must also have an "interest" in the timber. An interest means that you have the right (before entering into the 631(b) contract), if you so choose, to cut the timber in question for sale on your own account or for use in your trade or business.

The second provision concerns the definition of "timber." "Timber" for Section 631(b) purposes includes the parts of standing trees usable for lumber, pulpwood, veneer, poles, piling, crossties, and other wood products. Also included are evergreen trees that are more than 6 years old when severed from their roots and that are sold for ornamental purposes, such as Christmas trees. Section 631(b) does not apply to evergreen trees sold in a live state, whether or not for ornamental purposes. Tops and other parts of standing trees are not considered as evergreen trees, but may be considered as "timber" if utilized in the manufacturing process. The term "evergreen" is used in the commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other such coniferous trees.

The third provision concerns the date of disposal. This is the date the timber is cut. However, it is not usually practical to measure timber in the woods as the trees are severed. Therefore timber is considered "cut" when, in the ordinary course of business, the quantity felled is first definitely determined. This means that the date of disposal is the date on which the quantity of cut timber is first determined—whether at a log landing, wood yard, or mill—or after a follow-up timber cruise has been completed.

This definition of "cut" could help in determining whether a Section 631(b) disposal of timber qualifies for long-term capital gain status. You may not have owned the timber for the required holding period at the time it was felled. But, by the time it was measured, the holding period may have been met. However, the time of measurement cannot be purposely shifted merely to obtain a tax advantage.

If you include advance payments on your tax return as capital gain realized from the disposal of timber, and the cutting right expires, is terminated, or is abandoned before the timber that was paid for is cut, you must file an amended return. Such payments are then treated as ordinary income.

Your gain or loss from a Section 631(b) timber disposal is determined in exactly the same way as for a lump-sum sale, as discussed on page 27. It is reported as a section 1231 transaction, as discussed earlier in this section.

The Cutting of Standing Timber With An Election to Treat as a Sale (Section 631(a))

When standing timber is cut by the owner and the logs or products manufactured from them are sold, the entire proceeds must be reported as ordinary income unless a section 631(a) election is in effect. However, by making an election under section 631(a), you may cut timber for sale or for use in your trade or business and receive long-term capital gains treatment on the gain from holding it—just as if you had sold the standing timber outright instead of converting it yourself. In this case, the proceeds have to be divided into two segments: (1) the value added to the standing timber by converting it into products, and (2) the gain that resulted from holding the standing timber. Any profit realized from converting standing timber into products is always ordinary income, not a capital gain.

If you elect to use section 631(a), and the section 631(a) holding period has been met, the transaction is reported in two parts, as follows:

(1) Report as section 631(a) gain or loss the difference between the adjusted basis for depletion of the timber that was cut and its fair market value as standing timber on the first day of the tax year in which it was severed. This is treated as a section 1231 gain or loss that is netted with other section 1231 gains and losses you may have, and net gain is treated as long-term capital gain.

(2) Report as ordinary gain or loss the profit or loss resulting from conversion of the standing timber into products, such as sawlogs or pulpwood. The profit or loss is determined just as for any other business operation. The income received from the sale of the products is reduced by the cost of the timber plus the cost of converting it. The cost of the timber is the fair market value described in (1) above.

Six aspects of section 631(a) will be discussed in more detail—the meanings of owner, timber, timber use, holding period, fair market value, and how the election to use section 631(a) is made. An owner for section 631(a) purposes is essentially the same as for purposes of section 631(b). For purposes of 631(a) an owner is any taxpayer who has owned or held a contract right to cut timber for the required holding period. In order to have a contract right to cut timber, you must have the unrestricted right to sell the timber cut under the contract or to use it in your trade or business (see digest of Revenue Ruling 58–295, page 63). This means that if you were, for example, a logger who bought timber under a cutting contract, you would be the owner of that timber for Section 631(a) purposes just as if you had outright title to it, or to the land and timber together.

If, however, you have only a contract to cut timber and must deliver the logs back to the owner or to a buyer specified by the owner, you are merely performing a logging service and do not qualify as an owner or holder of a contract right to cut timber. A logging service contract that uses the terms "buy" and "sell" or "stumpage charge" will not meet the requirement to have a contract-right-to-cut in order to be considered an owner of the timber.

Timber for the purposes of section 631(a) is defined exactly the same as for section 631(b).

To qualify under section 631(a), the timber must be cut for sale or for use in your trade or business, not for personal use. This includes timber cut and sold as rough products (logs, pulpwood, fuel wood, etc.) or cut and used in a conversion business such as sawmilling. "Timber cut by the taxpayer" includes what you personally cut, as well as what is severed by persons whom you pay to do it for you.

The holding period under section 631(a) runs from the date you acquired the timber or the contract right to cut it to the date it is cut. As explained on page 28, timber is considered cut when, in the ordinary course of business, the quantity felled is first definitely determined.

The fair market value used as the sales price is that price at which the standing timber that was felled would have changed hands between a buyer and a seller on the first day of the tax year in which the trees were cut, assuming that both parties had reasonable knowledge of all the necessary facts and neither was required to buy or sell. The timber must be valued as it existed on the first day of the tax year regardless of any changes that occurred to it between that date and the date of the actual cutting.

The best indicators of fair market value are the actual prices paid for similar timber in the area in which the timber being valued was located. Such prices, however, have to be adjusted to account for any differences between the condition of the timber being valued and the markets for it, as compared to the timber for which actual prices are known. The fair market value used must be for the actual timber cut; it must be valued on its own merits and not on the basis of a general average for the region. Among the factors to be considered are the following:

(1) The character and quality of the timber as determined by species, age, size, and condition.

(2) The quantity of the timber per acre, the total quantity under consideration, and its location with reference to available markets.

(3) The accessibility of the timber from the standpoint of probable cost of cutting and transportation.

(4) The competition likely to develop from other timber buyers.

If you cut only a relatively small amount of timber during the year, you may be able to estimate its value by obtaining price information from mill operators and timber buyers in your area. However, if you cut a large amount, you should probably obtain an appraisal by a qualified timber appraiser such as a consulting forester.

You elect to use section 631(a) by merely computing your taxes according to its provisions. You indicate the election by answering the question in item 44 and supplying the information asked for in items 45 through 51 of Schedule F of Form T (see appendix II). The election must be made on the original tax return (including extensions) for the year to which it applies, and not on an amended return for that year.

An election under section 631(a) is binding with respect to all eligible timber you cut in the year of the election and in all subsequent years. The basic rule for discontinuance is that consent must be obtained from the IRS. This permission may be given only where there is a showing of undue hardship and—if given—consent to reelect must also be obtained. The 1986 Tax Reform Act, however, contains a special rule that permits timber owners who have been cutting under a Section 631(a) election with respect to a tax year beginning before January 1, 1987, to revoke it one time, and reelect one time, without such permission. Since the tax rate differential between ordinary income and net capital gains has been eliminated, revocation may be advantageous in the event cut timber is not sold in the same tax year in which it is severed. Without the revocation, you will be taxed in the year of cutting on the timber's gain in value as stumpage, even though no income has yet been realized from the sale of the products. For some owners, however, it may, as discussed on page 26, be more advantageous to retain capital gain status rather than revoke the election. The one-time revocation permitted by the 1986 Tax Reform Act can be made by simply attaching a statement made on a plain sheet of paper to the tax return for the year in which the revocation is to be effective.

Reporting requirements under section 631(a) are the same as for section 1231 gains and losses in general and for any other income realized from a trade or business. The gain or loss on the standing timber is reported on Form 4797 with other section 1231 transactions for the year, as discussed on page 28. The profit or loss from the sale of the cut products is reported on a business schedule—either Schedule C or Schedule F of Form 1040. The cost of the timber cut (the fair market value used for computing gain or loss) and the expenses of cutting and sale are listed as "other" expenses on Schedule F or Schedule C of Form 1040.

An attachment giving the details of the cutting and sale should be included with your tax return. Attach Schedule F of Form T or give the details required by Schedule F on a plain sheet of paper attached to your tax return. Be certain to include the details of how the depletion basis that was used, if any, was determined. Also include the information that was used to estimate the fair market value.

The following example illustrates how to determine the two parts of the gain realized under a Section 631(a) election.

Example 10

Election to treat cutting as a sale: You file your tax return on a calendar year basis, and you cut 60 MBF of timber during 1988 from a tract purchased in 1972. The sawlogs were piled at the roadside and sold, also in 1988. You received $9,600 for the logs. The fair market value of the standing timber that was cut was $125 per MBF, or $7,500, as of January 1, 1988. Your basis in the timber cut (determined as explained in "Determining the Amount of the Gain or Loss," page 23) was $1,460. Your logging and skidding costs totaled $1,500. Since you had owned the timber cut for more than one year, you elect to report the cutting under Section 631(a). You determine the gain or loss on the cutting of the timber separately from the gain or loss from the sale of the sawlogs, as follows:

Gain from cutting—	
Fair market value as of January 1, 1988, of timber cut during 1988	$7,500
Less: Allowable basis	1,460
Section 1231 gain	$6,040
Gain from sale of sawlogs at roadside—	
Proceeds from sale of sawlogs	$9,600
Less: Fair market value as of January 1, 1988, of timber cut and sold during 1988 (depletion allowance)	7,500
Logging costs	1,500
Cost of logs sold	9,000
Ordinary income	$ 600

You have a $6,040 gain to report with any other Section 1231 gains or losses on Form 4767, Part I. You also have income of $9,600 and expenses of $9,000 to report on either Schedule C or Schedule F of Form 1040. How to report Section 1231 gains and losses on Form 4797 was discussed on page 28.

Government Program Payments

Under Section 126 of the Internal Revenue Code, all or part of reforestation and certain other cost-sharing payments made to landowners under approved programs may be excluded from your taxable income. Expenditures for timber-stand-improvement practices and other costs that can be deducted annually (see page 19) do not qualify for the exclusion. This provision was not changed by the 1986 Tax Reform Act.

In general, a portion or all of a cost-share payment is excludable from taxable income if two provisions are met: (a) The payment is determined by the Secretary of Agriculture to be made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife, and (b) It is determined by the Secretary of the Treasury or the Secretary's delegate as not substantially increasing the annual income derived from the property. However, you may elect not to have this exclusion apply and include the entire amount of any payment as income.

The Secretary of Agriculture has determined that many State and Federal programs meet the above requirements. Forestry payments under both the Forestry Incentives Program (FIP) and the Agriculture Conservation Program (ACP) have been approved. Cost-share payments under the Conservation Reserve Program (CRP) are not currently eligible for exclusion. The full amount of CRP cost-share payments may, however, be taken into account as deductions from income as explained on page 13.

Since new programs are occasionally added to the list, you should check with the IRS, your State forestry office, or the local office of the Agricultural Stabilization and Conservation Service to see if a particular program qualifies.

The IRS regulations for Section 126 specifically disqualify for eligibility any government payment which is in the nature of rent or compensation for services. Therefore, recurring annual payments under CRP do not qualify for exclusion,

You have two options for reporting approved cost-share payments on your income tax return:

- **Option 1:** You may include the payment in your taxable income. If it was made for reforestation, you may take both the amortization and investment tax credit (explained on page 13) on the total cost of the reforestation—including the share you pay plus the cost-share payment—up to $10,000 paid or incurred per tax year.
- **Option 2:** You may exclude all or part of the payment from your taxable income. If you exclude all or part of the payment you should include a statement with your tax return stating the total cost of reforestation, the amount of the payment, date received, purpose of the payment, and the amount excluded. You may not claim the tax credit and amortization on the excluded portion of the cost-share payment.

In general, the part of a cost-share payment that is excludable from taxable income is the present fair market value of the right to receive annual income from the affected acreage of the greater of these two amounts: (1) 10 percent of the average annual income derived from the affected property prior to reforestation or other qualifying activity, or (2) an amount equal to $2.50 per acre times the number of affected acres. The regulation further specifies that prior average annual income means the average of the gross receipts from the affected acreage for the last three tax years preceding reforestation. Example 11 explains how much reforestation cost can be deducted.

Example 11
Deduction of Reforestation Costs: Assume you reforested 100 acres at a cost of $100 per acre, for a total cost of $10,000. You receive a 50 percent cost-share payment of $5,000. Your average annual income from the land in the 3 previous years was $15,000, and the interest rate is 8 percent.

The method of determining the present fair market value of the right to receive income and which interest rate to use is not specified in the regulations. However, Section 2032A (e)(7)(A) of the Internal Revenue Code, pertaining to valuation of farm and forest land for estate tax purposes, specifies a procedure of dividing annual income by the Federal Land Bank interest rate to determine the capital value. This procedure does not necessarily apply to Section 126, but is used to illustrate the calculations.

Assume that the average annual Federal Land Bank interest rate is 8 percent. Ten percent of the $15,000, or $1,500, is capitalized, by dividing it by .08, which provides $18,750. Since $18,750 exceeds the $5,000 cost-share payment, the entire $5,000 is excludable. If there had been no harvest or any other income from the land in the previous 3 years, the value of the right to receive $2.50 per acre for the 100 acres, or $250, is determined by dividing $250 by .08. The capitalized amount, $3,125, is the amount that could be excluded from taxable income, leaving a balance of $1,875 that would have to be included in income. Note, however, that the tax credit and amortization could then be claimed on the amount included as explained on page 13.

If the trees are disposed of within 10 years of establishment, then the lesser of: (1) the amount of gain from the disposal, or (2) the amount of cost-share payment excluded, will be recaptured as ordinary income. This base recapture amount is reduced by 10 percent for each year or portion of a year if disposal occurs between 10 and 19 years. For timber held more than 19 years there is no recapture upon disposal. Form 4797 is filed to declare the recaptured amounts as income.

Other Timber-Related Receipts

Ordinary gains or losses result from the sale of products produced from timber. This rule applies to all products derived from harvested trees such as logs, lumber, pulpwood, poles, mine timbers, crossties, fence posts, fuelwood, and chips. It also applies to products derived from the trees as they stand, such as gum naval stores, maple syrup, fruit, nuts, bark, and Christmas greens. Gains from the sale of trees for landscaping purposes, such as balled nursery stock, are also ordinary income.

Tree stumps from cutover land are sometimes an exception. If you make a lump-sum sale of tree stumps from cutover timberland acquired for investment, you may be entitled to treat any gain from the sale as a capital gain (see summary of Revenue Ruling 57–9, page 65). However, you must sell all the stumps on the property at one time. Capital gains treatment does not apply to gains from the sale of stumps by persons in the timber or stump business—either as a buyer, seller, or processor. Therefore, proceeds from the sale of tree stumps by timber operators after the trees have been harvested are ordinary income.

Gains from the sale of limbs and tops that are left after logging are also ordinary income, even if the timber was subject to a Section 631(a) election.

Chapter VII. Other Tax Considerations

Installment Sales

Introduction

The number of tax brackets was substantially reduced by the Tax Reform Act of 1986. Nevertheless, it may still be to your advantage to spread the receipt of income from the sale of timber over more than one tax year. Such sales are referred to as installment or deferred payment sales. The elimination of income averaging beginning in 1987 means that an installment sale is the only way to spread the tax burden from a timber sale over more than one tax year. There are limitations on the use of the installment sale method, with certain dispositions of real property held for sale to customers or used in a trade or business, but these do not apply to the disposition of timber by taxpayers whose timber ownership qualifies as a farm business under section 2032A of the Internal Revenue Code.

The receipt of payments in more than one tax year could arise from either a lump-sum sale or a "pay-as-cut" contract. A typical lump-sum sales contract might require an initial down payment, a minimum annual payment, and payment in full before timber cutting starts. A typical pay-as-cut contract might require an initial down payment and monthly payments based on the volume cut and scaled during the previous month. If a pay-as-cut contract qualifies for treatment under section 631(b), the contract is not treated as an installment contract and the section 631(b) rules apply as discussed in Chapter VI.

The installment sale provisions apply automatically whenever at least one payment is received in a tax year after the tax year of the sale. The installment sale provisions do not apply to rent received from a timberland lease. The provisions also do not apply to sales resulting in a loss. Losses must be reported in full in the year incurred.

Calculating Installment Sale Income

Any stated interest included in a payment is reported separately as ordinary income. This is also the case for imputed interest, discussed later in this chapter. The rest of each payment is treated as if it were made in two parts. One part is a return of your investment (basis) in the timber you sold plus your cost to sell the timber. The other part is your gain from the sale. The gain will be capital gain if the timber you sold was a capital asset and was held for more than one year. The two parts are calculated using the gross profit percentage.

Gross Profit Percentage—The percentage of a payment that is gain usually remains the same for each payment. This percentage is determined by dividing the gross gain from the sale by the contract price, as explained on Form 6252. The method of calculating gross profit percentage is shown in example 12.

Example 12
Calculating gross profit percentage: You sell timber at a contract price of $2,000, and your allowable basis in the timber sold is $400. Your cost to sell the timber was $100. The total gain on the sale is $1,500 ($2,000 − $100 − $400) and your gross profit percentage is 75 percent ($1,500 ÷ $2,000). After subtracting out interest, 75 percent of each payment, including the down payment, should be reported as your gain from the sale in the tax year in which you receive the payment.

Adjusted allowable basis—The adjusted allowable basis for timber sold is the allowable basis determined by multiplying the appropriate depletion unit by the number of units sold, explained more fully on page 23. From the selling price you subtract the selling expenses paid in connection with the sale and your adjusted allowable basis to determine the gross gain.

Selling price—The selling price is the entire cost of the timber to the buyer. It includes any money and the fair market value of any property you are to receive from the buyer. It also includes any debt which the buyer takes the property subject to, pays, or assumes. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the timber. If the buyer pays any of your selling expenses for you, that amount is also included in the selling price.

If the selling price is reduced at a later date, the gross gain on the sale must be refigured. You then calculate a new gross profit percentage which applies to any remaining payments. You cannot go back and refigure the gain you reported in earlier years.

Payments—You must figure your gain on the payments you receive each year from an installment sale, including the down payment and each later payment of principal on the buyer's debt to you. The buyer's note (unless it is payable on demand) is not considered a payment on the sale. Its full face value is included when figuring both selling price and contract price. The payments you receive on the note generally are reported on the installment method.

Escrow Accounts—In some cases, the sales agreement, or a later agreement, may call for the buyer to establish an irrevocable escrow account out of which some or all of the remaining installment payments, including interest, are to be made. An escrow account is irrevocable if the buyer cannot revoke the account and recall the funds to his own use. Generally, these sales may not be reported on the installment method. The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account. When the escrow account is established, you no longer rely on the buyer for the rest of the payments, but on the escrow arrangement.

If an escrow arrangement imposes a substantial restriction on your right to receive the sale proceeds, the sale may be reported on the installment method, provided it otherwise qualifies. In order for an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the buyer—that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the buyer. Because of the nature of most timber sale transactions, irrevocable escrow accounts will usually preclude installment reporting.

Electing Out—You can choose not to have the installment sales rules apply to your sale. If you make this election, you must report your entire gain from the sale on your return for the year of sale, even though you will not be paid all of the selling price until later. The election is made by not reporting the sale on Form 6252. Instead, report it on Schedule D of Form 1040, or Form 4797 if the timber is used in or held for sale as a trade or business. To figure the selling price under this election, you must compute the buyer's installment obligation to you at its fair market value.

Unstated Interest and Imputed Interest—If the note or other document of indebtedness you receive from the buyer provides for no interest on the deferred payments or provides for inadequate interest as defined in IRS regulations, you are required to impute interest. Imputed interest is reported in the same manner as stated interest.

Generally, a document of indebtedness provides for adequate stated interest if it calls for interest at a rate no lower than the test rate of interest. For seller financing of less than $2,800,000, the test rate of interest is the lower of the applicable Federal rate of interest or 9 percent compounded semiannually. Each month the IRS issues tables giving the applicable Federal rate for short-term (3 years or less), mid-term (over 3 years but not more than 9 years), and long-term (more than 9 years) debt instruments. The tables applicable to your sale can be obtained by calling the IRS's toll free taxpayer assistance number.

Imputed interest rules may apply to any document of indebtedness issued for the sale or exchange of your property if some or all of the payments scheduled under the debt instrument are due more than 6 months after the date of the sale or exchange under a contract which: (1) some or all of the payments are due more than one year after the date of the sale or exchange, and (2) there is total unstated (or inadequately stated) interest. The imputed interest rules do not apply if the sales price will not exceed $3,000. IRS Publication 537 provides information for determining imputed interest.

Reporting Installment Sales—Installment sales are reported on Form 6252. This form is used to report the original sale in the year it takes place, and to report payments received in later years. The sale also should be reported in the year it takes place on Form T, discussed on page 30.

Sales to Related Parties—If you make an installment sale of timber to a related party who then makes a second disposition within 2 years of the first disposition, and before all payments are made under the first disposition, a special rule may come into effect. Under this rule, part or all of the amount the related person realizes as a result of the second disposition is treated by you at the time of the second disposition as if you had received it from the first disposition. See IRS Publication 537 for details.

Casualties, Thefts, and Condemnations

If part or all of your timber is destroyed or stolen, or if your forest land is condemned for public use, you may be entitled to claim a deduction on your income tax return. To do this, you need to know the kinds of losses that are deductible, the structure of your activity, how to determine the amount of loss recognized for tax purposes, and how to determine the type of deduction—capital or ordinary. The nature of the deduction also depends on your purpose for holding the timber. If, because of salvage operations, insurance recovery, or other compensation, the destruction, theft, or condemnation results in a gain, you must include the gain in your income, unless you elect to postpone reporting such gain, as explained later in this section.

Operating losses, discussed in Chapter V, are created when expenses associated with a trade or business, or an investment activity, exceed income in a tax year. Such losses do not involve the involuntary conversion of property discussed in this section.

The three basic categories of involuntary losses—physical damage or destruction, thefts, and condemnations—are discussed in this chapter. Note that under certain circumstances a deductible loss results from the destruction or damage to property held as part of a trade or business or for the production of income even if the loss is not caused by a "casualty." Since losses resulting from theft (sometimes referred to as "timber trespass") and condemnation of property for public use are treated similarly to casualty losses, the discussion focuses on casualty losses first. The unique aspects of thefts and condemnations are then discussed separately.

Discussion Limited to "Timber"

This publication discusses timber held for the production of income as either a business or investment. If your timber is held for personal use see IRS Publication 547 "Nonbusiness Disasters, Casualties and Thefts." You should consult IRS Publication 547 for the treatment of losses involving shade trees.

Normal Losses Not Deductible

To be allowed as a deduction, a loss must be evidenced by a closed and completed transaction fixed by an event or identifiable events and must actually have been sustained during the tax year. Timber lost due to natural factors typically associated with timber stands, referred to as natural mortality, is not a casualty loss. Natural mortality includes trees killed by overtopping of larger, faster growing trees; normal levels of disease and insect infestations; and low rainfall. Natural mortality is reflected in your timber volume accounts, as discussed on page 23.

Physical losses of timber will generally come under the heading of casualties, that is, losses caused by natural or other external forces acting in a sudden, unexpected, and unusual manner. A sudden event is one that is swift, not gradual or progressive. An unexpected event is one that is ordinarily unanticipated and one that you do not intend. An unusual event is one that is not a day-to-day occurrence and one that is not typical for the activity in which you were engaged when the damage or destruction occurred.

Noncasualty Losses

Damage or destruction of timber held for the production of income as a trade or business, or investment, may result in a deductible noncasualty loss if the precipitating event is unusual and unexpected. Circumstances generating noncasualty losses are contrasted with casualty losses in the discussion below.

Casualty Losses

Casualty losses include but are not limited to those resulting from fire, hurricane or other casualties such as windstorm, sleetstorm, and hail. Casualty losses also include destruction or damage from plane crashes, automobile accidents, or similar events.

Disease or Insect Infestation—Trees grown for timber that are killed by disease or insect infestation do not ordinarily result in a casualty loss. Losses resulting from a low level of pest incidence, usually present under normal conditions, are not deductible. If the trees killed are shade trees, the sudden, unexpected, and unusual damage resulting from the southern pine bark beetle may be deductible as a casualty loss (see summary of Rev. Rul. 79–174, page 66). In addition, some attacks of southern pine bark beetles may result in an unexpected and unusual noncasualty loss of timber which gives rise to a deductible loss (see summary of Rev. Rul. 87–59, page 65).

Loss of Potential Income Is Not Deductible—A loss of future profits is not deductible. For example, if an ice storm damages standing timber and reduces its rate of growth or the quality of future timber, the loss is not deductible. The same is true for site damage. To qualify as a casualty, the damage should cause existing timber to be unfit for use.

Combinations of Factors—Combinations of factors sometimes cause timber damage. A nondestructive fire may be followed by insect attacks. Trees weakened by interior rot or characterized by shallow root systems may be uprooted or broken off as a result of repeated windstorms or may die as a result of drought. When combinations of factors are involved, it may be necessary to consider the length of time from the precipitating event to the eventual loss of the timber to determine the suddenness of the loss.

Every reasonable effort should be made to salvage the affected timber. When losses of this character are heavy but the timber is not salvageable, you should adjust your timber accounts to reflect the loss of timber volume as an offset against growth in computing the depletion unit.

Determining the Amount of Deductible Loss—If your timber is destroyed by fire or other casualty, your deductible loss is the allowable basis in the timber destroyed less any insurance or other compensation received (see summary of Rev. Rul. 66–9, page 65). Timber damaged but not made unmerchantable should be salvaged if possible. If a gain results from the salvage activity, there is no casualty loss with respect to the salvaged timber. Determine your gain or loss from the salvage cutting, sale, or other disposal as you would for timber sales in general. If you are not able to salvage the timber after making a bona fide attempt to do so and claim a loss deduction, you should keep a record of your efforts in order to show that the timber was not salvageable.

Determining Volume of Timber Destroyed—To claim a loss deduction, the single identifiable object damaged or destroyed must be identified. For timber, this is expressed in terms of the specific units destroyed. The units of measurement used should be those utilized to maintain your timber accounts, such as board feet, cords, or cubic feet.

The number of units of timber destroyed must be established by fair and reasonable measurement to justify a deduction. You may wish to employ a consulting forester to cruise the timber if the area is extensive and much work is involved. In many cases, however, the local public forester, or other representative of the State forestry department may be able to furnish you with an estimate of the quantity destroyed.

Determining Basis of Timber Destroyed—Determine the basis of timber destroyed as you would for a sale or other disposition, as discussed in "Determining the Amount of Gain or Loss," page 23. First, determine the depletion unit by dividing the adjusted basis for depletion as shown in your timber account by the quantity of merchantable timber in the account. Then, multiply the depletion unit by the number of units destroyed to find the amount allowable as a loss. The volume used to calculate the depletion unit for the loss should include adjustments for growth for the year of the casualty but is not reduced by the volume of timber destroyed. If your timber has no basis, you will not have a deductible loss.

Year of Deduction—A loss arising from a casualty generally is deducted in the year in which the casualty occurs. This is true even if you have not yet settled a reimbursement claim or have not received an agreed upon insurance settlement or other compensation. If a claim for reimbursement has been made, and you think you will recover all or part of the loss even though you have not yet received payment by the time the tax return for the year of the casualty is due, reduce the reported loss by the amount you expect to recover. If you later recover less than the amount you estimated, you may deduct the difference for the year in which you become certain that no more reimbursement or recovery can be expected (see example 13).

Example 13
Adjustment of loss deduction claimed: Timber that you owned was destroyed by fire in 1987. The allowable basis of the timber destroyed was $800, and you expected to recover $600 of the loss from fire insurance on the timber. Even though the insurance company does not make payment to you in 1987, your loss for 1987 is limited to $200, the difference between the loss and the amount you expect to recover. In 1988, the company offers to settle the claim for $500, and you accept. The $100 difference between the amount you expected and what you actually received may be claimed as a casualty loss on your return for 1988.

Report as income any reimbursement for more than the amount expected. If, after you have claimed a deduction for loss, you receive reimbursement for more than you estimated would be recovered (but not more than the total amount of the loss computed), you must include such excess as income on your return for the year received. Do not file an amended return for the year in which you claimed the deduction (see example 14).

Example 14
Adjustment of loss deduction claimed: Timber that you owned was destroyed by fire in 1987. For tax purposes, your loss from the casualty was $1,000, and you estimated that insurance would cover $750 of the loss. You therefore claimed a loss of $250 on your 1987 return. In 1988 the insurance company pays you $850, or $100 more than you estimated in computing your deductible loss for 1988. The $100 difference is included as income on your return for 1988.

Destruction of Unmerchantable Timber—The destruction of a premerchantable plantation or stand of naturally regenerated young growth may result in a deductible loss. You can claim a loss only if (1) you maintain separate plantation or young growth accounts, as explained in "Timber Accounts," page 12 and (2) you have costs allocated to such accounts (see summary of Rev. Rul. 81-2, page 63). In addition, under certain circumstances the death of newly planted seedlings due to an unusual and unexpected drought may qualify as a noncasualty loss.

If these requirements are satisfied, generally you may figure your allowable basis for the unmerchantable timber destroyed by dividing the cost shown in the account by the number of acres in plantation or young growth, and then multiplying that amount by the number of acres destroyed.

Buildings and Equipment—If buildings and equipment used in your business or held for the production of income are totally destroyed, your deductible loss is the adjusted basis of each specific item of property destroyed, less salvage value and less any insurance or other compensation received or expected to be received (see example 15). If such property is only partially destroyed, your deductible loss is limited to whichever is less—either your adjusted basis reduced by any compensation you receive, or the decrease in the fair market value of the property reduced by any compensation (see example 16).

Example 15
Loss when property is totally destroyed: Your sawmill was completely destroyed by a fire and you carried no insurance on the property. The adjusted basis for depreciation of the sawmill building and equipment at the time of the fire was $6,500, and its fair market value is $5,000. The value of the equipment after the fire was only scrap value, amounting to $300. Your deductible casualty loss is $6,200, the adjusted basis of $6,500 less salvage value of $300.

Example 16
Loss when property is partially destroyed: Assume that the sawmill in example 15 was damaged by the fire but not completely destroyed. Just before the fire the sawmill had a fair market value of $5,000 and immediately after the fire its fair market value was $3,500. Under these facts, your loss is limited to $1,500, the decrease in the fair market value, since this amount is less than the adjusted basis of $6,500.

Had the fair market value of the sawmill been $8,000 just before the fire and $1000 just afterward, the decrease in fair market value would be $7,000 and your deductible casualty loss would be limited to your $6,500 adjusted basis in the property.

Determining the Decrease in Fair Market Value—The decrease in the fair market value of property resulting from a casualty should be determined by an appraisal of the values of the property immediately before and immediately after the casualty. The decrease is the difference between these two values. Your cost of restoring and cleaning up after the casualty may be acceptable as evidence of the decrease in the value of the property if: (1) such costs are necessary to restore the property to its precasualty condition, (2) the amount spent for restoration is not excessive, (3) the expenses do no more than take care of the damage suffered, and (4) the value of the property after restoration is not more than its value before the casualty.

Theft Losses

Determine the amount of loss you can claim from a theft of timber, frequently referred to as "timber trespass," as you would for a casualty loss. Your deductible loss is the allowable basis of the timber stolen—that is, the depletion unit multiplied by the number of units stolen—less insurance, damages or other recoverable amounts received.

Year Deducted—Generally, theft losses are deducted in the year the theft is discovered. To establish a theft loss, you do not have to prove when the timber was stolen, only that the theft occurred, that you owned the property, and when you discovered it. Thus, the quantity of timber used in determining the depletion unit is the quantity at the time the theft is discovered.

Reduce Theft Loss by Anticipated Recovery—Your theft loss must be reduced by any amounts you expect to receive as a result of the theft. This is required even though you do not receive payment until after the close of the tax year. Also, if you are reimbursed in a later year for more than you anticipated when you estimated the amount of the deductible loss, include the excess as ordinary income on your return for the year in which you receive it, as discussed with respect to casualty losses.

Multiple Damages—In many States successful prosecution of timber trespassers results in the awarding of compensation to the victim. The award is sometimes two or three times the fair market value of the timber stolen. In the case of double or treble damages, one-half or one-third respectively of the award represents compensation for the timber stolen. This amount should be reported as proceeds of an involuntary conversion. The gain is determined as for any other disposal. The other one-half or two-thirds, representing a damage award, is fully taxable as ordinary income. It should be reported as "other income." An attachment explaining the entries made on your return should be filed with the return.

Condemnations

A condemnation is the lawful taking of private property by a government body for public use without the consent of the owner, but with payment of compensation. The tax consequences are the same if you sell property under threat of condemnation. Therefore, if the public condemning authority tells you that it intends to acquire your property by negotiation, or if necessary by condemnation, and you sell the property to the authority at a mutually agreeable price, treat the sale as if your property had actually been condemned and you were granted an award.

The computation of your gain or loss when your forest land is condemned or sold under the threat of condemnation will in all cases involve the land, but may or may not involve standing timber, depending on whether you are permitted to harvest it. Determine the basis of your timber as you would for an ordinary sale. Your land account should show the part of the original total basis that was allocated to land, exclusive of timber and any improvements (see page 12). The basis of the land condemned or sold under threat of condemnation is its basis as shown in the land account (see example 17).

Example 17
Condemnation: You purchased a 50-acre timber tract and allocated $200 per acre, or $10,000, to the land account. A strip of land totaling 5 acres and running through the property was condemned for use in building a new highway. The basis of the land (exclusive of timber) to be used in computing the gain or loss on the condemnation is 5/50ths of $10,000 or $1,000.

Condemnations for Right-of-Way Easements—Condemnations of forest land for utility or other right-of-way easements generally involve the taking of any timber growing on the right-of-way and the right to grow future timber crops thereon, but not legal title to the land. The award received is reported as described above for the land and the timber. No deduction is allowed for future timber income foregone.

Basis for Figuring Gain or Loss—The basis of the timber condemned is your depletion unit multiplied by the number of units standing on the property condemned, or by the number of acres times the basis per acre for plantations or stands of young growth. If, however, the condemning authority allows you to harvest the merchantable timber before the land is taken, and you sell the timber, or cut and sell the logs or other products, only the land would be involved in the computation. The gain or loss on the timber would be reported separately as described above.

Condemnation of property for public use can raise many specialized questions. For example, besides receiving an award for your condemned property, you might also receive severance damages or consequential damages resulting from a decrease in value or damage to that part of your property not condemned. A condemnation might also result in a special assessment being charged to you because of resulting improvements to your retained property. For a detailed explanation of the treatment of these special problems, see IRS Publication 549, "Condemnations and Business Casualties and Thefts."

Recovery of Expenses

Expenses are handled differently for casualties and thefts than they are for condemnations.

Casualties and Thefts—Appraisal, timber cruising, and other ordinary and necessary expenses for determining your loss are expenses in determining your tax liability. They are not part of the loss, but may otherwise be deductible.

Condemnations—Legal, appraisal, timber cruising, and other expenses incurred to receive a condemnation award are deducted from the award to determine the net award reported on your tax return.

Postponing Gains From Involuntary Exchanges

You may be able to defer gains realized from a forced disposition of timber as a result of an unexpected and unusual event, such as when the trees are killed by fire or an unexpected and unusual insect attack, or downed by high winds, earthquake, fire, ice storms, or volcanic eruption. These events generally require a conversion of the timber soon after the event or you will suffer a complete loss of it. To defer any gains realized you must use the proceeds (amount realized) to purchase qualifying replacement property (see summary of Rev. Rul. 80-175, page 66). Amounts realized from the involuntary conversion of timber include the amount realized from a lump sum sale of the timber, the amount realized under Section 631(b) in the case of disposition of the timber under a pay as cut contract, and the fair market value under 631(a) in the case of cutting the timber by the taxpayer. The purchase of qualifying replacement property includes the purchase of replacement timber sites; the cost of seeds and seedlings; your costs to plant the trees or sow the seed on currently owned, leased, or replacement timber sites; and the cost of purchasing stock in the acquisition or control of a corporation owning timber, timberlands, or both.

An involuntary exchange occurs when your property is completely or partially destroyed, stolen, requisitioned, condemned for public use, or disposed of under the threat or imminence of condemnation and you receive insurance or a condemnation award. Involuntary exchanges are also called involuntary conversions. If you have a gain resulting from an involuntary exchange, you may elect to postpone paying tax on all or part of the gain even though the involuntary exchange may not necessarily qualify as a casualty. This occurs, for example, when damages are awarded by court order, or when parties who have damaged your property make a voluntary settlement. An example would be a settlement made by a logger working on property next to yours who inadvertently removed timber from your side of the property line.

Determining the Gain—A gain is realized on an involuntary conversion when the insurance, condemnation award, or other compensation that you receive is greater than your basis in the property. The amount of the gain is determined as described above for casualties, thefts, and condemnations. If you harvest your involuntarily converted timber instead of disposing of it on the stump, and a 631(a) election is in effect, the amount of the gain, if any, is based on the fair market value of the stumpage cut as described on page 29. Ordinarily, you would include the gain on an involuntary conversion in your income for the year it is realized. However, under certain conditions, you may defer the gain or a portion of it until you sell the replacement property you bought with the proceeds. The amount of the gain qualifying for deferment cannot exceed the fair market value of the assets converted.

Requirements to Postpone Gain—Your gain is not taxed in the year realized if within the allowable replacement period you purchase other property that is similar or related in service or use to the property converted, or the controlling interest in a corporation owning such property, at a cost that equals or exceeds the amount you received as compensation. For the condemnation of real property, such as timber, the replacement period ends three years after the close of the first tax year in which any portion of the gain from the conversion is realized. The replacement period is two years for property other than real property.

If you elect to defer reporting the gain, you must file a statement with your tax return stating that the election is being made and including all the pertinent information concerning the conversion and the replacement property. If you make the election, but do not spend all of your compensation, reimbursement, or proceeds on qualifying replacement property, you must report the difference as income.

Basis of replacement property—Your basis in replacement property is its cost minus any gain that you postpone. In this way, tax on the gain is deferred until you dispose of the replacement property.

Reporting Gains and Losses From Casualties, Thefts, and Condemnations

Gains and losses are reported differently for casualties and thefts than they are for condemnations.

Casualties and Thefts—You first use Form 4684, "Casualties and Thefts," to calculate and report casualty and theft losses and gains. Section B of Form 4684 is used for losses and gains from business and income-producing property. Your losses and gains are reported according to how long the property was held and the purpose for which it was used—such as business, rental, to produce royalties, or for investment.

You may also be required to file Schedules C, D, and F of Form T.

Each item of property for which you are claiming a loss or gain must be listed separately. If more than four items were involved in any one casualty or theft, attach additional copies of the form. If you incurred losses or gains from more than one event you must use a separate Form 4684 for each event. Form 4684 summarizes your casualty and theft losses and gains and directs you to the proper form for reporting each.

Reporting Gain or Loss—Property Held for 1 Year or Less—Short-term losses (held 1 year or less) on business, rental, or royalty-producing property are combined on Form 4684 with your short-term gains from casualties and thefts. The resulting net gain or loss is reported on Form 4797.

Reporting Gain or Loss—Property Held for More than 1 Year—Long-term losses (held more than 1 year) on business, rental, or royalty-producing property are combined with your other long-term casualty and theft losses on Form 4684. Compare the combined losses to your long-term gains from casualties and thefts of business, rental, or royalty-producing property. If the combined losses are the same as or less than the gains, net the combined losses against your gains. Then enter the net gain on Form 4797.

If your combined losses are more than the gains, your long-term gains and losses are treated as ordinary gains and losses. Merge your long-term losses with your long-term gains.

Reporting Gain or Loss From Income Producing Property—Your short-term losses from income producing (investment) property are reported on Schedule A of Form 1040. Gains from short-term income producing property are added to your gains from business, rental, and royalty-producing property to be offset against short-term losses from business, rental, and royalty-producing property.

Your total long-term loss on income producing property is reported on Schedule A, Form 1040.

Condemnations—The way in which you include a taxable gain or deductible loss from a condemnation in computing your income depends on the kind of property involved, when you acquired it, how long you held it, and whether or not a part of your gain is due to depreciation. Do not include condemnation gains in taxable income if you elect to defer tax on the gain by acquiring replacement property, as discussed above.

Property Held for 1 Year or Less—You treat a gain or loss from property used in your business or held for the production of rents or royalties as ordinary gain or loss on Form 4797. You report a gain or loss from property you held for investment as a short-term capital gain or loss on Schedule D, Form 1040.

Property Held for More Than 1 Year—If you held property for more than 1 year before it was condemned or sold under a threat of condemnation, you must list the gain or loss on Form 4797, together with any other gains and losses on other Section 1231 property.

Property Held Primarily for Sale—You report a gain or loss from property you held primarily for sale to customers in the ordinary course of business as ordinary income or loss. You use the appropriate business schedule, either Schedule C or F of Form 1040, regardless of how long the property was held. You never report such transactions on Schedule D of Form 1040 or on Form 4797.

Property Held for Personal Use—You report the gain from property held for personal use as a short-term or long-term gain on Schedule D of Form 1040. Under no circumstances may you deduct a loss from the condemnation of property that you held for personal use.

For more information, see IRS Publication 549, "Condemnations and Business Casualties and Thefts."

Example 18

Comprehensive example: Walter Green owns 320 acres of timberland which was affected by hurricane force winds on April 10, 1987. Walter is a calendar year taxpayer, holds the timber for use in a trade or business activity, and materially participates in this activity. He maintains one timber account for all of the stands. The damage varied among the stands of loblolly and shortleaf pine of various ages. Almost all of the trees in some stands were uprooted and splintered so as to be unsaleable. Some stands or parts thereof were subject only to windthrow. Other stands or parts thereof suffered little damage.

Walter identified the stands that were undamaged and instructed his consulting forester to cruise all the other stands to determine the extent of the damage. He used the cruise data and on-the-ground inspections to determine the stands that needed to be treated by a salvage cut. These stands were put up for sale in July, but by December 31, 1987, no offers had been received. The timber buyers Walter contacted all told him that because of the large acreage of timber damaged that spring there was more timber available than could be absorbed by the market. They suggested he contact them next spring.

Walter claimed as a loss his basis in the 1,200 cords of wood totally destroyed. The basis was determined as shown in figure 8. Walter reported the loss on Schedule C (Form 1040), Schedules D and F (Form T), Form 4684, and Form 4797.

On November 10, 1988, Walter was able to sell the stands identified for salvage. In 1987 the forester estimated that these stands contained 2,100 cords. The buyer, however, estimated that the stands contained only 1,800 cords of merchantable wood. The difference was due to the degradation over two summers since the hurricane. Walter received $16,500 for the 1,800 cords. The allowable basis for this sale was determined as shown in figure 9. The $1,182 loss should be reported as a noncasualty loss in 1988. The $9,408 gain on the salvage sale ($16,500 − $7,092) is reported on Schedule C of Form T. If he elected to pay tax on the gain he would report it on Form 4797 as an involuntary conversion. If Walter elected to postpone paying tax on the gain by replanting the stands, or otherwise acquiring qualifying replacement property, he would file an attachment to his 1988 return detailing such things as all facts relating to the hurricane, the amount realized on the sale, his computation of the gain, any gain to be reported, and the type and cost of replacement property acquired. If the replacement property would be acquired after the time for filing the return, Walter should indicate in the statement that he intends to acquire replacement property within the required time period. In the subsequent year of acquiring replacement property, a statement should be attached to the return giving detailed information on the replacement property.

Figure 8—**Schedule F (Form T)**
Capital Returnable Through Depletion

Line number on Form T	Quantity in board feet, log scale, or other unit (1)	Cost or other basis (2)
28. Estimated quantity. . . [at end of 1986]	5,000 cords	$22,300
30a. Addition for growth (1 year)	220	—
33. Total at end of year, before depletion	5,220	22,300
34. Unit rate	—	4.27
39. Quantity of timber lost by fire or other cause during year	1,220	—
40. Allowable basis of loss		5,124
42. Net quantity and value at end of year	4,200	17,176

Figure 9—**Schedule F (Form T)**
Capital Returnable Through Depletion

Line number on Form T	Quantity in board feet, log scale, or other unit (1)	Cost or other basis (2)
28. Estimated quantity. . [at end of 1987]	4,200 cords	$17,176
30a. Addition for growth (1 year)	160	—
33. Total at end of year, before depletion	4,360	17,176
34. Unit rate	—	3.94
37. Quantity of timber sold	1,800	—
38. Allowable as basis of sale		7,092
39. Quantity of timber lost by fire or other cause during year	300	—
40. Allowable basis of loss	—	1,182
42. Net quantity and value at end of year	2,260	8,965

Alternative Minimum Tax

The purpose of the alternative minimum tax is to make certain that if your income tax liability is reduced because of certain tax benefits, you will pay at least a minimum amount of tax.

Your potential liability for the alternative minimum tax depends on the structure of your timber activities, your other sources of income, and the deductions you claim. Timber income does not create a tax preference directly subject to the alternative minimum tax. Timber sale income may, however, increase your total taxable income sufficiently to indirectly trigger an alternative minimum tax liability. This would be the case if your income is increased above the exempt amounts specified for the alternative minimum tax and you have realized certain tax benefits related to all of your activities.

The deduction of your timber management expenses may also trigger a minimum tax liability. This is the case if you recover your expenses as miscellaneous itemized deductions on Schedule A, Form 1040, discussed in more detail on page 22. Also, if you are not materially participating in the conduct of your timber activity, as discussed on page 21, any passive loss generated by your timber activity may trigger an alternative minimum tax liability. For additional information see IRS Publication 909 "Alternative Minimum Tax."

The alternative minimum tax is determined by completing Form 6251. It is not possible to determine with certainty whether or not you are liable for the tax without completing this form.

The alternative minimum tax is calculated by first determining your alternative minimum taxable income, defined as the sum of (1) the taxable income as determined on your Form 1040; (2) any net operating loss deduction claimed; and (3) adjustments pertaining to the standard deduction, medical and dental expenses, miscellaneous itemized deductions, taxes, certain interest, tax shelter farm loss, and passive activity loss, among others. To this sum you also add your tax preference items relating to accelerated depreciation on real property placed in service before 1987; accelerated depreciation on leased personal property in service before 1987; charitable contributions of appreciated property; incentive stock options; tax exempt interest on certain private activity bonds; and percentage depletion (this does not apply to timber) among others (see IRS Publication 909 "Alternative Minimum Tax"). The final step is to subtract from this total your alternative tax net operating loss deduction.

The alternative minimum tax is calculated by:
(a) Computing 25 percent of the greater of zero or the amount by which alternative minimum taxable income exceeds $150,000 ($75,000 if married and filing separately, $112,500 if single or head of household).
(b) Subtracting the amount determined in (a) from $40,000 ($20,000 if married filing separately, $30,000 if single or head of household). If zero or less, use zero.
(c) Determining 21 percent of the greater of zero or the amount by which the alternative minimum taxable income exceeds the amount determined in (b).
(d) Reducing the amount determined in (c) by the alternative minimum tax foreign tax credit.
(e) Reducing the amount determined in (d) by the regular tax before credits minus foreign tax credit. This is the alternative minimum tax due. It is paid in addition to the regular tax.

Self-employment, Social Security Tax

You may owe the self-employment tax if you are engaged in a timber trade or business as a sole proprietor, independent contractor, or member of a partnership. This tax provides social security coverage to the self-employed. The tax is imposed on self-employment income, which includes annual net earnings by an individual from a trade, business, or profession. In general, you must pay self-employment tax if you have net earings from self-employment of $400 or more. However, no self-employment tax is due on self-employment income if you had employee wages of a specified amount ($48,000 in 1989) or more subject to either social security tax, railroad retirement tax, or both. You may be liable for paying the tax even if you are fully insured under social security or are now receiving benefits. Also, you are liable for the tax regardless of your age, and even if you are not otherwise required to file a federal income tax return.

If income from your timber operations is considered as received in the course of a trade or business, it may be subject to the self-employment tax even though your timber transactions are infrequent and you are primarily engaged in some other business, trade, or profession. For example, a farmer whose property includes a tract of timber or a person employed in the city and owning woodland outside the city, who occasionally cuts timber for firewood and sells it, may be liable for self-employment tax on the income received.

Treatment of Spouses

The services of an individual who works for his or her spouse are subject to the social security tax. If, however, you and your spouse join together in the conduct of a business and share in its profits and losses, a partnership may have been created. If so, you and your spouse should report the business income on a partnership return, Form 1065. Attach Schedules K-1 to Form 1065 to show each partner's share of the net income, and file separate Schedules SE (Form 1040) to report self-employment tax.

Excluded Income Items

The following timber-related items are not included in computing net earnings from self-employment:

1. Rental payments received for the use of real estate and personal property leased with real estate if you are not a real estate dealer and you do not materially participate in the rental activity.
2. Gains that qualify for capital gains treatment.

Gains from the sale or other disposal of standing timber generally qualify for capital gains treatment if the timber is not held primarily for sale to customers in the ordinary course of a trade or business in which you are engaged or you dispose of it under the provisions of Section 631(b), as discussed on page 28. If you cut the timber yourself or have a contract logger cut it for you, and elect to treat the cutting as a sale under the provisions of Section 631(a), discussed on page 28 the gain determined under section 631(a) would not be included in net income from self-employment. Your profit on the sale of the logs or manufactured products, however, may be subject to the self-employment tax.

Christmas Tree Growers

Growers of Christmas trees are subject to the rules applicable to timber producers in general. The self-employment tax applies to ordinary income received from the sale of trees. Gains from the sale of Christmas trees may qualify as capital gains, as discussed on page 41, and therefore not be subject to the self-employment tax.

Forest Products

The sale of forest products other than standing timber, and a cutting not under a Section 631(a) election, usually produces ordinary income. Receipts from these sources are therefore included in self-employment income.

Agricultural Conservation Program Payments

Net payments received under the Agricultural Conservation Program (ACP) and federal Forestry Incentive Program (FIP), as well as those received under state cost-share programs are included in self-employment income, unless specifically excluded from reportable income for Federal income tax purposes. All or some portion of such program payments may qualify for such exclusion under rules discussed on page 30. Only the portion actually excluded from taxable income may be excluded from self-employment income.

Net conservation Reserve Program (CRP) payments are also generally included in self-employment income. CRP payments do not currently qualify for income tax exclusion under the rules discussed on page 30. However, if the payments are treated as a conservation expense under Section 175 of the Code, they become a deduction in determining net earnings from self-employment.

How to Calculate Self-employment Tax

The self-employment tax is calculated by completing Schedule SE of Form 1040, "Computation of Social Security Self-Employment Tax." The maximum amount subject to the self-employment tax is the amount equal to the contribution and benefit base determined under Section 230 of the Social Security Act. For 1989, the amount is $48,000. This maximum includes both self-employment earnings subject to the tax and wages subject to social security or railroad retirement withholdings. The effective self-employment tax rate in 1988 and 1989 is 13.02 percent.

If you work for wages subject to withholdings that equal or exceed the maximum amount subject to the social security tax, and also have income from a trade or business, you do not pay self-employment tax on your earnings from the trade or business. However, if you work for wages subject to withholding that total less than the maximum amount, and also have income from timber operations subject to the self-employment tax, your gains from timber operations will be taxed to the extent of the difference between your wages and the maximum.

Including Timber Gains In Self-employment Income To Guarantee Benefits

Qualification for social security benefits for you or your dependents depends in part on how much social security tax you have paid. If you are not certain that you will qualify for full benefits on retirement, you should check on your status by contacting the Social Security Administration Office listed in your phone book under "United States Government, Social Security Administration."

If you need to make additional contributions you may prefer not to make an election under Section 631(a) to treat the cutting of timber as a sale. If you are a farmer who cuts and sells timber, you may, for the sake of obtaining benefits, decide not to make the election. If so, include your timber income and expenses, and the basis of the timber sold, as farm income and expenses on Schedule F of Form 1040. Such income would be subject to self-employment tax and would be reported on Schedule SE of Form 1040. Remember, however, that if the Section 631(a) election has been made in prior years, you may not forgo the election in any following year without permission of the IRS. There is a one time exception to this rule, however, as discussed on page 30.

If you dispose of standing timber held primarily for sale to customers in the ordinary course of a trade or business, the gain will be ordinary income subject to the self-employment tax, unless you dispose of it in such a way that the provisions of Section 631(b), discussed on page 28, apply.

If your timber is not held primarily for sale and you sell it "on the stump" (lump-sum sale) the gain usually is a capital gain and is not subject to the self-employment tax.

For more information on the self-employment tax, see IRS Publication 533, "Self-Employment Tax." If you are a farmer, refer to Publication 225, "Farmer's Tax Guide."

Christmas Tree Production

Most Christmas tree producers are subject to the same Federal income tax provisions as timber owners in general. Both the Internal Revenue Code and the Regulations provide that for purposes of Section 631 the term "timber" includes evergreen trees that are more than 6 years old at the time severed from their roots and sold for ornamental purposes. This definition includes Christmas trees.

Christmas tree growing generally constitutes a trade or business. As such, capital gains treatment depends on qualifying for treatment under Section 631(a) if you cut the trees yourself, or Section 631(b) if you sell the trees "on the stump." The rules are the same as for any other timber grower, as explained in Chapter VI.

Typically, "choose and cut" Christmas tree sales do not qualify for capital gains treatment under Code Section 631(b)—see Revenue Ruling 77-229, page 64. In the usual situation, the grower lends a saw to a customer who chooses and cuts a tree, pays for it at a previously agreed upon price, loads the tree into his car, and leaves the farm. Under these circumstances, the buyer does not have a contract-right-to-cut the tree as required under Section 631(b)—he may not cut a tree at all, at his option. When the customer cuts a tree however, he or she has an obligation to purchase it. Therefore, the grower is considered to be selling cut trees, and should elect Section 631(a) to receive capital gains treatment.

Reporting the cutting of Christmas trees as a sale under Section 631(a) is done the same as for other types of timber, as described on page 28. The fair market value of the trees cut should be determined as of the first day of the tax year for the purpose of determining the Section 631(a) gain.

Example 19 shows how capital gains are calculated for Christmas tree operations.

Example 19
Capital gains on Christmas tree operations: You are a calendar year taxpayer, and you established 5 Christmas tree plantations in 5 successive years, each comprising 10 acres and each containing 12,000 trees of fast growing pine species. Two-year-old nursery stock was used, so the trees in the first plantation are now above the minimum age (more than 6 years) required to qualify as timber under Section 631(a) of the Internal Revenue Code.

You spent $1,210 to establish the first plantation. Later, you incurred $1,060 in capital costs, representing (a) certain carrying charges you had elected to capitalize; and (b) the cost of replanting lost trees. The adjusted basis just before the first cutting in November of that year thus amounted to $2,270. An inventory showed that there were now 11,000 well-formed trees present. Of these, 6,000 were of sizes to be cut this year and 5,000 were to be left for further growth. A depletion unit of $0.21 per tree was derived by dividing the $2,270 adjusted basis by 11,000 trees.

You cut the 6,000 salable trees yourself and delivered them to a wholesaler. You received $4.30 per tree from the wholesaler. The total cost to you for cutting and delivering the trees was $1,800.

You elect on your tax return to treat the cutting of the trees as a sale under Section 631(a) of the Internal Revenue Code.

The value on January 1 can be estimated by discounting the value when cut for 10 months as follows. Assume the trees were worth $3.60 each on November 1 when cut and that the applicable local interest rate is 10 percent.

$$\frac{\text{Value}}{(1.0 + (i/12))^{10}} = \frac{\$3.60}{(1 + 0.10/12)^{10}} = \$3.31$$

You determine your taxable gain as follows:

Gain from cutting:		
6,000 trees cut with an established fair market value of $3.31 per tree as of January 1		$19,860
Less:		
Basis for gain or loss at $0.21 per tree		(1,260)
Gain on timber (taxed as Section 1231 gain)		$18,600
Gain on sale of trees:		
6,000 trees sold for $4.30 per tree		$25,800
Less:		
Depletion allowance (Jan. 1 fair market value of $3.31 per tree)	$19,860	
Cost of cutting and delivering	1,800	(21,660)
Gain from harvesting and delivering (taxed as ordinary income)		$ 4,140

If you had not harvested the trees but had entered into a cutting contract with a jobber, you would calculate the gain as follows:

6,000 trees sold for $3.60 per tree		$21,600
Less:		
Basis for gain or loss at $0.21 per tree	$ 1,260	
Expenses for administering cutting contract	120	(1,380)
Income		$20,220

If the cutting contract qualified as a disposal with an economic interest retained under the provisions of Section 631(b), the $20,220 would be reported as a Section 1231 gain. Otherwise this amount would be reported as ordinary income.

Costs of shearing and basal pruning of Christmas trees are deductible business expenses (see summary of Rev. Rul. 71-228, page 63). This only applies, however, if the trees were originally planted and grown as Christmas trees. It does not apply to trees that were regenerated naturally and are being converted to Christmas trees.

Current expenses incurred with respect to Christmas trees may be subject to the passive loss rules as disussed on page 20. Also, producers of Christmas trees that are 6 or fewer years of age when cut are subject to the uniform capitalization rules. In general, the uniform capitalization rules require that the preproductive costs must be capitalized if the preproduction period of a crop is more than 2 years. However, the law permits certain farmers to elect not to have the uniform capitalization rules apply. If the election is made, (1) any gain on the sale of the crop is recaptured as ordinary income to the extent of the deductions permitted by the election, and (2) you must use the alternative depreciation system (using the straight line method, without regard to salvage value) for all farm assets placed in service in any year the election is in effect.

Chapter VIII. Researching a Tax Question

Very few sections of the Internal Revenue Code were written specifically for timber activities. Hopefully, this publication will answer most of your questions if you are a nonindustrial private timber owner. This chapter introduces the steps involved in researching tax questions not adequately covered in this handbook or IRS publications.

Before attempting to conduct research yourself, consult a comprehensive treatise, such as the "Tax Treatment of Timber." This and several other advanced publications are discussed in Chapter IX. Most likely the discussions in these publications will adequately address your questions.

If it is necessary to research a specific issue, several basic questions must be addressed. You must determine which sections of the Code apply—the statutory law; how these sections are interpreted by the IRS—administrative interpretations; and how these sections are interpreted by courts—case law. The final step is to determine how this total body of law and interpretations applies to your factual situation.

Statutory Law

The Internal Revenue Code forms the foundation of Federal income tax law. The Code is promulgated by acts of the U.S. Congress. The U.S. Constitution requires all revenue bills to be initiated in the House of Representatives. When a revenue bill is introduced by a member of the House, the bill is referred to the House Committee on Ways and Means. If the committee recommends further action on the bill, public hearings are held. The Senate also considers the bill. The Senate Finance Committee may hold hearings. Differences between the House and Senate passed versions of the bills are reconciled in the Joint Conference Committee which may also hold hearings. When the bill completes the legislative process and is signed by the President, it becomes part of the Internal Revenue Code of 1986, as amended.

The records of these hearings and committee reports provide information on what the legislators hoped to accomplish by enacting the law. This legislative intent is important in interpreting the law when there is doubt about specific language included in the law.

If you are unfamiliar with tax law it may be difficult to determine which sections of the Code apply to a particular tax question. You could start by consulting one of the detailed treatises listed in the bibliography. These publications contain footnotes and other references to the Code sections applicable to the issue being discussed. The major commercial tax services, such as Commerce Clearing House's "Standard Federal Tax Reporter," Prentice-Hall's "Federal Taxes," and Research Institute of America's "Federal Tax Coordinator" could also be consulted. These services include a comprehensive index which will refer you to the proper Code section. "Timber Tax Journal" also contains an index.

Tax indices are designed for users familiar with tax law. Most topics are indexed according to tax issues and use tax terms. For example, questions involving which costs can be deducted, or in tax terms, "expensed currently," are indexed in "Timber Tax Journal" under Capital vs. Expense. If you have a question regarding the tax year in which timber income is reported, you should look under "installment contracts" or "accounting rules." IRS Publication 17, "Your Federal Income Tax" explains in plain language the tax law on many items of general interest.

Administrative Law

The Commissioner of Internal Revenue is charged with implementation of the Code. The first step is to write and issue Treasury Regulations interpreting the Code and specifying how it is to be implemented. These regulations have the force and effect of law. However, the courts may nullify regulations that are not consistent with the Code (and the intent of Congress). After drafting, internal study, and review, regulations are issued as proposed regulations and/or as temporary regulations. Temporary regulations have the force of law and must be followed. Regulations generally become permanent only after the public has had the opportunity to comment on them and these comments are evaluated. The temporary regulations are superseded when final regulations are issued.

New regulations and amendments to existing regulations are issued as Treasury Decisions and published in the "Federal Register" and "Internal Revenue Bulletin." It would be impossible to write regulations covering all possible circumstances. Thus, other types of rulings and forms of communication are also used in administering the Code.

Revenue Rulings

Revenue rulings (Rev. Rul.) are official interpretations by the IRS of the Code, related statutes, tax treaties, and regulations that have been published in the Internal Revenue Bulletin. They are published for the information and guidance of taxpayers, IRS personnel, and others. Generally, a revenue ruling tells what to do. They may be used as authority.

General Counsel Memoranda

General Counsel Memoranda (G.C.M.'s) are internal working documents of the IRS reflecting the opinion of its attorneys on a specific issue. G.C.M.'s reflect the logic behind the official position taken by the IRS in a revenue ruling, response to a court ruling, etc.

Revenue Procedures

Revenue procedures are official statements of a procedure published in the Internal Revenue Bulletin that either affect the rights and duties of taxpayers or other members of the public under the Code, related statutes, tax treaties, and Regulations, or, although not necessarily affecting the rights and duties of the public, should be a matter of public knowledge. In general, a revenue procedure tells you how to do something.

News Releases, Notices, and Announcements

Matters of immediate and general concern to taxpayers may be addressed in news releases that are provided to the media. Notices and announcements address similar matters and may be released as news releases or published in the *Internal Revenue Bulletin*. The subject matter usually involves recent changes in the law, and, in particular, points of confusion which have arisen as a result of changes.

Private Letter Rulings

A private letter ruling is a written statement issued to a taxpayer by the National Office of the IRS that interprets and applies the tax laws to that taxpayer's specific set of facts. Although these letter rulings are made available to the public, you should not rely on a ruling issued to another taxpayer. Instructions for a taxpayer to request a ruling are in a revenue procedure that is updated annually. Under present law, payment of user fees is required for requests made before September 30, 1990.

Technical Advice Memoranda

A technical advice memorandum consists of advice or guidance furnished by the National Office of the IRS upon request of a District or an Appeals Office in response to any technical or procedural question that develops during any stage of any proceeding on the interpretation and proper application of tax law, tax treaties, regulations, revenue rulings, or other precedents published by the National Office to a specific set of facts. Although these memoranda are made available to the public, you should not rely on a technical advice memorandum with respect to another taxpayer. Either the IRS District or Appeals Office, or the taxpayer may initiate the action to request technical advice. Instructions on requesting technical advice are published in a revenue procedure that is updated annually.

Case Law

If a question is clearly covered by the Code, you must follow the Code or seek legislative remedy—that is, have the Code changed. If your circumstances are covered by the Regulations or Revenue Rulings, then you must follow them or expect that the IRS will challenge any contrary position taken. If you disagree with the position taken by the IRS in proposing adjustments to your tax, then you may appeal through the administrative appeals process and may have to defend your position in court. Sometimes your circumstances may not be specifically covered by the Code, regulations, rulings, court cases, etc. In that case, you and your advisors must interpret the law yourselves, consistent with what you believe to be Congressional intent, and seek justification for your interpretation in the general body of tax literature.

Case law consists of the findings of the various Federal courts on those tax questions brought to trial. The significance of the findings of a court on an income tax matter varies greatly, depending on the particular court involved and the response of the IRS to the findings of the court.

The types of courts are reviewed first. Then the possible responses of the IRS to court rulings are reviewed. Finally, guidelines on how to interpret court decisions are provided.

Federal Court System

If you and the IRS still disagree after your appeals conference, you may take your case to either the U.S. Tax Court, the U.S. District Court for the district in which your tax home is located, or the U.S. Claims Court. These courts are independent judicial bodies and have no connection with the IRS.

If you elect to bypass the IRS appeals system, you may take your case to any of the above-mentioned courts. However, a case petitioned to the U.S. Tax Court will normally be considered for settlement by an appeals office in the IRS region before the Tax Court hears the case. Where the taxpayer elects to bypass the IRS's appeals system, the Ta Court may impose a penalty of up to $5,000 if it appears to the Tax Court that the taxpayer unreasonably failed to pursue available administrative remedies. Generally, findings o these courts may be appealed to a higher court. The appeals process is discussed under Audits and Appeals, page 45. The following Federal courts hear tax cases.

Tax Court—The Tax Court was created by Congress specifically to hear federal tax cases. The court is an independant court with its principal address in Washington, DC, but hears cases throughout the Nation in designated Federal court rooms. The Tax Court has jurisdiction of a case only if the IRS issues a statutory notice of deficiency. You have 90 days (150 days if mailed to you outside the United States) from the date the notice is mailed to file a petition with the Tax Court. Generally, the Tax Court hears cases only if the tax has not been assessed and paid; however, you may pay the tax after the notice of deficiency has been issued and still petition the Tax Court for review. If your case involves a dispute of not more than $10,000 for any one tax year or period, the Tax Court provides a simple alternative for resolving disputes. At your request, and with the approval of the Tax Court, your case may be handled under "the small tax case procedures" whereby you can present your own case to the Tax Court for a binding decision. If your case is handled under this procedure, the decision of the Tax Court is final and cannot be appealed. You can get more information regarding the small tax case procedures and other Tax Court matters from the U.S. Tax Court, 400 Second Street, N.W., Washington, DC 20217.

District Courts and Claims Court—Generally, the District Court's and the Claims Court hear tax cases only after you have paid the tax and have filed a claim for a credit or refund with the IRS. You may file a claim for a credit or refund if, after you pay your tax, you believe the tax is incorrect. If your claim is rejected by the IRS, you will receive a notice of disallowance of the claim unless you signed a Form 2297, Waiver of Statutory Notification of Claim Disallowance. If the Service has not acted on your claim within 6 months from the date you filed it, you may then file suit for refund. You must file a suit for a credit or refund no later than 2 years after the Service disallows your claim or a Form 2297 is filed.

You may file your suit for credit or refund in your United States District Court or in the United States Claims Court. However, the Claims Court does not have jurisdiction if your claim is for credit or refund of a penalty that relates to promoting an abusive tax shelter or to aiding and abetting the understatement of tax liability on someone else's return.

Circuit Courts of Appeals—The findings of either the Tax Court or Federal District Courts can be appealed by either the taxpayer or the Government to the appropriate Circuit Court of Appeals. Appeals from the Claims Court are heard by the Court of Appeals for the Federal Circuit.

U.S. Supreme Court—The findings of Circuit Courts of Appeals and the Court of Appeals for the Federal Circuit may be reviewed by the U.S. Supreme Court. The taxpayer or the government may file a petition for "writ of certiorari" (request to be heard) with the Court. If the Justices agree to hear the case a writ of certiorari will be granted. Otherwise certiorari will be denied and the findings of the appeals court are binding on the parties.

Interpreting Case Law

Findings of the U.S. Supreme Court become law and must be followed by the IRS. This is not the case with decisions of lower courts which find against the Government or Commissioner of Internal Revenue. In such cases, if the court finds for the taxpayer in whole or in part, such findings are controlling—assuming no appeal is made—only upon that particular taxpayer for the years involved. The IRS may, however, concur with certain findings by formally issuing an announcement of "acquiescence." This means that the IRS will apply the findings of the court as regards the specific points of law involved to other taxpayers as well. The IRS may also announce its "nonacquiescence" which means that it will not follow the findings of the court and any taxpayer relying on this case as precedent very likely will be challenged by the IRS. In most cases the IRS lets the case stand without issuing an announcement.

In the process of interpreting and applying the Internal Revenue Code to particular factual circumstances, the courts create nuances in the law. Since the Federal courts follow the common law system, relying on precedents instead of on a strict case-by-case reading of the statutes, court decisions can be cited to support a position. Precedents must be used appropriately, however. First, the precedent cited should be "on point," i.e., deal with the same point of law as is involved in the present case. Second, the precedent should be applicable to the jurisdiction in which the case would be tried, if taken to court. Other cases from the same Federal district or circuit carry the most weight. Decisions from other districts or circuits may be cited, but need not be followed unless the case has been upheld by the Federal Appeals Court for the taxpayer's jurisdiction. U.S. Supreme Court decisions are precedent in any jurisdiction. Decisions by the Court of Appeals for the Federal Circuit are precedent in the Claims Court.

Audits and Appeals

Special audit programs have been developed to monitor abusive tax shelters. Timber related activities are not generally considered as abusive tax shelters. Although auditors are provided with special industry guidelines concerning what to look for in auditing returns that report timber transactions, your likelihood of being audited is not known to be changed by virtue of your timber activities.

How Returns are Selected for Examination

Your return may be examined to verify the correctness of income, exemptions, credits, or deductions or other entries under two programs. The Discriminant Function System (DIF) is a computer program that evaluates entries on your return and assigns a score related to the probability that an entry is erroneous. IRS personnel screen the returns based on the computer scores and select for examination those with a high probability of error. Returns may also be selected under the Taxpayer Compliance Measurement Program (TCMP). This is a random selection system used to evaluate overall compliance and provide the statistical base used to score returns under the DIF program.

The Examination Process

If your return is selected for examination you will be notified in writing. The notification will inform you of the method of examination and the records you will need to make available to the examiner to clarify or support entries on your return. The examination may be conducted by correspondence, or it may take place in your home or place of business, an Internal Revenue Service office, or the office of your attorney or accountant. Although the place and method of examination are determined by the IRS, if the place is not convenient for you the examiner will try to work out something more suitable.

Whatever method of examination is used, you may act on your own behalf or you may have someone represent you or accompany you. If you filed a joint return, either you or your spouse, or both, may meet with the examiner. An attorney, a certified public accountant, a person enrolled to practice before the IRS, or the person who prepared the return and signed it as the preparer may represent or accompany you. You must furnish your representative with written authorization. Form 2848, Power of Attorney and Declaration of Representative, or Form 2848–D, Tax Information Authorization and Declaration of Representative, or any other properly written authorization may be used for this purpose.

Generally your tax return is examined in the IRS District where you live. However, at your request, the examination may be moved to another district for a reasonable cause.

If You Agree—If you agree with the findings of the examination, you will be asked to sign an agreement form. If you owe additional tax, you may pay it when you sign the agreement. If you pay when you sign the agreement, interest is charged on the additional tax from the due date of your return to the date you pay.

If you do not pay the additional tax when you sign the agreement, you will receive a bill for it. The bill will include interest on the additional tax from the due date of your return to the billing date. If the tax is not paid within 10 days after the billing date, interest starts accruing again.

If the examination results in a refund you will receive interest at the applicable rate on the refund.

If You Do Not Agree—If you do not agree with the changes proposed by the examiner, the examiner will explain your appeal rights. This includes your right to request an immediate meeting with a supervisor to explain your position. If agreement is not reached at this meeting, or if the examination takes place outside of an IRS office, the IRS will send you:

1) A letter notifying you of your right to appeal the proposed adjustment within 30 days,
2) A copy of the examination report explaining the proposed adjustments,
3) An agreement or waiver form, and
4) A copy of IRS Publication 5, "Appeal Rights and Preparation of Protests for Unagreed Cases."

If after receiving the examination report you decide to agree with the findings, you sign the form and return it to the examiner. You may pay any additional amount and the applicable interest you owe without waiting for a bill.

If after receiving the examination report you decide not to agree with the examiner's findings, the IRS urges you to appeal your case within the IRS before you go to court. Most differences can be settled with an appeals office in the region without the need to go to court.

How to Stop Interest from Accruing—You can stop the further accrual of interest on any amount the IRS claims you owe or you believe they will claim you owe by remitting the appropriate amount to the IRS. Your remittance may be made either as a deposit in the nature of a cash bond (deposit) or as a payment of tax. If you also want to stop the accrual of compound interest, you should remit any interest due. Deposits differ from payments in that you can request the return of a deposit at any time without filing a claim for a refund. However, deposits will not be returned if the IRS has determined that returning it will jeopardize collection of a possible deficiency or that it should be applied against another tax liability. Also, deposits do not earn interest.

If at the end of the examination you agree with the findings of the examiner, your deposit will be applied against the amount you owe. A notice of deficiency will not be mailed to you and you will not have the right to take your case to the Tax Court.

Appeals Within the IRS

There is a single level of appeal within the IRS. Your appeal from the findings of the examiner is to an appeals office in the region which is independent of the District Director. Appeals conferences are conducted as informally as possible. If you want an appeals conference, address your request to your District Director according to the instructions in the letter you will receive. If agreement is not reached at your appeals conference, you may, at any stage of the procedures, take your case to court.

Along with your request for a conference, you may need to file a written protest or brief statement of disputed issues with your District Director. Such filings are unnecessary if the proposed increase or decrease in tax, including penalties, or claimed refund, due to a field examination is not more than $2,500 for any of the tax periods involved, or your examination was conducted by correspondence or in an IRS office by a tax auditor. If the proposed increase or decrease in tax, or claimed refund, is more than $2,500 but not more than $10,000, an appeals office conference will be granted if a brief written statement on the disputed issues is provided. You should list in the statement the unagreed adjustment(s) and the reason you disagree with each. A written protest of disputed issues is required to obtain an appeals office conference if the proposed increase or decrease in tax, or claimed refund, is more than $10,000. In addition, a written protest is required to obtain appeals consideration in all partnership and S corporation cases, as well as in two others. See IRS Publication 556 for more information on appeal rights, including guidance on preparing a written protest.

Appeals to the Courts

If you and the IRS still disagree after your conference, or if you bypassed the appeal process within the IRS, you may take your case to the United States Tax Court, the United States Claims Court, or your United States District Court as explained earlier. Even if you elect to bypass the IRS's appeals system, a case petitioned to the United States Tax Court will normally be considered for settlement by an Appeals Office before the Tax Court hears the case. If you are a prevailing party in a civil court case against the Service, you may be entitled to recover reasonable litigation costs, if:

1) You exhaust all administrative remedies within the IRS.
2) Your net worth is below a certain limit, and
3) You do not unreasonably delay the proceeding.

For information about procedures for filing suit in the courts, contact the Clerk of the Tax Court, the Clerk of your District Court or the Clerk of the Claims Court. Addresses of the courts are given in IRS Publication 556.

Claims for Refund—Once you have paid your tax, you have the right to file a claim for a credit or refund if you believe the tax was calculated incorrectly and is too much. If you filed Form 1040, Form 1040, or Form 1040EZ, you may claim a credit or refund by filing Form 1040X, "Amended U.S. Individual Income Tax Return." Mail it to the Internal Revenue Service Center where you filed your original return. A separate form must be filed for each tax year or period involved. Include an explanation of each item of income, deduction, or credit on which you are basing your claim.

A claim for a credit or refund must be filed within 3 years from the date the original return was filed or within 2 years from the date the tax was paid, whichever is later. Original returns filed before the due date are considered to have been filed on the due date.

Additional Information—For additional information consult IRS Publication 5, "Appeal Rights and Preparation of Protests for Unagreed Cases," and IRS Publication 556, "Examination of Returns, Appeal Rights, and Claims for Refund."

Example of Tax Research

As an example of tax research procedures, assume you execute an oral agreement to sell timber "on the shares" to a logger. The logger agrees to cut your timber, sell the logs produced to a sawmill, and give you 40 percent of the amount received from the sawmill for the logs. You are not certain how to report the payments you receive from the logger on your tax return, i.e., whether as capital gain or ordinary income, and how to recover your basis in the timber cut.

From reading this publication, you are aware that capital gains treatment depends on how you dispose of timber and your primary purpose for holding it. If you "dispose" of timber on the stump and the timber is a capital asset in your hands, the proceeds are reported as a capital gain if you held the timber for more than one year. If you held the timber primarily for sale to customers in the ordinary course of a trade or business, your disposal must meet the requirements of Section 631(b) to qualify for capital gains treatment. If you sell products from your timber cut by you or by others providing a logging service for you, you do not qualify for capital gains treatment on the proceeds from the sale of the logs, but may elect to treat the cutting of the timber as a sale under the provisions of Section 631(a) of the Internal Revenue Code.

Since you have conducted many timber sales from your land in the 20 years you have owned it, receive a substantial portion of your total income from these timber sales, and in general conduct your timber related activities in a manner consistent with being in the business of selling timber, you conclude that your timber is held primarily for sale.

The next question is whether you have disposed of timber on the stump, or whether the logger is providing a logging service under the oral contract and is selling the logs produced on your account. Since nothing in the Internal Revenue Code or Regulations specifically deals with oral timber agreements, you must research case law for guidance. In the index of "Timber Tax Journal" under "disposal with a retained economic interest," you find several cases. The first one listed is *Ah Pah Redwood Co. v. Commissioner*, 26 T.C. 1197 (1956) (reversed in part and remanded), 251 F.2d 163 (9th Cir. 1957), 18 T.C.M. 202 (1959), which happens to involve an oral agreement. By reading this case you find that the Court concluded that the oral contract in question was valid under the laws of the state in which it was executed because real property to be severed upon sale was not subject to the contract law generally applicable to a sale of real estate (Statute of Frauds didn't apply). Since the same law applies in your state you conclude that your oral agreement with the logger is an enforceable contract. But in reading *Ah Pah Redwood Co.*, you note that the Court ruled that the taxpayer could get capital gains treatment under a disposal with an economic interest retained only if the taxpayer was **not** holding the timber primarily for sale. This Court's ruling conflicts with the discussion in this publication, which says that disposals qualifying under Section 631(b) receive capital gains treatment regardless of the purpose for which the timber was held. Upon further investigation, the index in "Timber Tax Journal" refers you to Revenue Ruling 57-90 (1957-1 C.B. 199) in which the IRS notes that the findings of the court in *Ah Pah Redwood Co.* regarding this issue are inconsistent with the IRS's position and rules that finding of the Court will not be followed by the IRS.

In analyzing whether you have disposed of your timber with an economic interest retained, you conclude that you in fact did dispose of the standing timber to the logger. Under the oral agreement the logger was obligated to cut the timber the logger could sell the logs to any mill he chose, you could not dispose of the same timber to anyone else, and you had no control over the logger's activities other than to assure that his activities didn't cause serious soil erosion or damage field crops.

You also conclude that you retained an economic interest in the timber disposed of since you would be paid only for the timber actually cut and sold. The logger didn't agree to pay you any fixed amount.

Therefore, you conclude that under the terms of the shares agreement in question, payments you received from the logger during the tax year qualify for long-term capital gains treatment under Section 631(b) of the Internal Revenue Code, and that your basis in the timber disposed of is recovered as the allowable basis of this timber, as discussed on page 23.

Chapter IX. Sources of Tax Assistance

There are many sources of assistance available to you on federal taxation. The IRS's taxpayer assistance program, for example, has trained personnel answering toll-free taxpayer service phones to deal with many tax questions. Also, there are publications by the IRS and others dealing with federal taxation, in general, and with the tax treatment of timber related activities, which can be complex.

IRS Publications

The IRS maintains a comprehensive taxpayer publications program designed to provide you with up-to-date tax information. No IRS publication deals specifically with timber, however. This publication supplements these taxpayer publications by compiling the tax information directly impacting timber owners. The IRS publications providing the general tax background needed to handle timber transactions are cited in the text of this handbook. Single copies of IRS publications can be obtained at no charge from the IRS.

The following IRS publications contain background information that may be helpful in understanding the tax treatment of timber activities.

Association Publications

The Forest Industries Committee on Timber Valuation and Taxation, (FICTVT) 1250 Connecticut Ave., N.W., Washington, DC 20036 has available several publications. The current charge for and availability of these publications can be obtained by contacting the FICTVT.

"Timber Tax Journal" (Vols. 1 to 20) is an annual compilation of timber tax developments, including cases, rulings, a bibliography, and summaries of substantive articles. The comprehensive index and accompanying findings list provide citations to the basic authorities on almost all topics. Original articles are also published.

"Tax Treatment of Timber," by Charles W. Briggs and William K. Condrell, is an authoritative treatment of the income tax aspects of timber transactions written in law review style. It is revised periodically as needed.

Publication No.	Title
5	Appeal Rights and Preparation of Protests for Unagreed Cases
17	Your Federal Income Tax A comprehensive guide for individual taxpayers.
216	Statement of Procedural Rules—Conference and Practice Requirements
225	Farmers Tax Guide. A comprehensive guide for farmers. This taxpayer publication contains much information about timber transactions.
334	Tax Guide for Small Business. A comprehensive guide for owners of small corporate and noncorporate businesses. Few timber transactions are discussed.
463	Travel, Entertainment, and Gift Expenses
505	Tax Withholding and Estimated Tax
527	Residential Rental Property
529	Miscellaneous Deductions
533	Self-Employment Tax
534	Depreciation
535	Business Expenses
537	Installment Sales
538	Accounting Periods and Methods
539	Employment Taxes
541	Tax Information on Partnerships
542	Tax Information on Corporations
544	Sales and Other Dispositions of Assets
545	Interest Expense
547	Nonbusiness Disasters, Casualties, and Thefts
549	Condemnations and Business Casualties and Thefts
550	Investment Income and Expenses
551	Basis of Assets
552	Recordkeeping for Individuals and a List of Tax Publications
556	Examination of Returns, Appeal Rights, and Claims for Refund
572	General Business Credit
584	Nonbusiness Disaster, Casualty, and Theft Loss Workbook
586A	The Collection Process (Income Tax Accounts)
909	Alternative Minimum Tax for Individuals
910	Guide to Free Tax Services
925	Passive Activity and At-Risk Rules

Commercial Tax Services

Several publishing companies specialize in providing tax information. They publish multivolume comprehensive loose-leaf Federal income tax services updated weekly. Timber transactions are discussed under the applicable code sections. Many public libraries receive at least one of these services.

Commerce Clearing House, Inc. 4025 W. Peterson Avenue, Chicago, IL 60646, publishes "Standard Federal Tax Reporter." Prentice-Hall Information Services, 240 Frisch Court, Paramus, NJ 07652 publishes "Federal Taxes." Research Institute of America, Inc, 589 Fifth Avenue, New York, NY 10017, publishes "Federal Tax Coordinator."

Commerce Clearing House, Inc. also publishes "Energy Resources Tax Reporter." This service deals specifically with the tax treatment of oil, natural gas, coal, and timber. It includes monthly updates on current developments. It provides a general discussion on the tax treatment of timber transactions for readers familiar with the basics of federal income tax.

Prentice-Hall also publishes "Income Taxation of Natural Resources," by Charles W. Russell and Robert W. Bowhay. This annual publication provides a textbook-style treatment of the timber-related tax aspects of the timber industry along with the oil and gas industry.

Other Sources

Several other sources of tax information are available. Some of these specialize in reporting current developments and providing tax tips, while others provide basic guidance on the tax and related financial aspects of timber investments.

Current Developments

Current developments are reported in "The American Tree Farmer," a magazine published by the American Forest Council. 1250 Connecticut Avenue, N.W., Suite 320, Washington, DC 20036. Each bimonthly issue includes a tax column discussing current developments and a detailed treatment of a particular issue.

"Forest Farmer," published by the Forest Farmers Association, P.O. Box 95385, 4 Executive Park East, N.E., Atlanta, GA 30347 is a magazine published ten times per year. At least one issue per year is devoted primarily to timber tax developments. Other issues provide legislative updates.

Guidebooks

"Christmas Tree Taxation Manual," by Vernon L. Bowlby, C.P.A., Bowlby Publishing Company, Inc. 310 N.W. 5th Street, Suite 206, Corvallis, OR 97330, featuring a looseleaf service and related materials available from the author, provides a comprehensive guide to the tax treatment of Christmas trees and an associated recordkeeping system.

"A Guide to Income Tax Records for Tree Farmers," by Harry L. Haney, Jr., is published by the Virginia Cooperative Extension Service Publication 420–090, Virginia Polytechnic Institute and State University, Blacksburg, VA 24061. This booklet contains recordkeeping guidelines, comprehensive examples, filled out forms, and sample accounts.

"Timber Tax Management for Tree Farmers," by William L. Hoover, is published by American Forest Council, 1250 Connecticut Ave., N.W., Washington, DC 20036. This is a loose-leaf timber tax guide that is updated at least annually. The basic tax considerations of timber owners and strategies are covered. Comprehensive examples and associated filled out tax forms are included. This is an introductory guide.

"Essentials of Forestry Investment Analysis," by John E. Gunter and Harry L. Haney, Jr., is available from the Oregon State University Book Stores, Inc., P.O. Box 489, Corvallis, OR 97339. This book describes the discounted cash flow procedures used to analyze timber investments on a before- and after-tax basis. Procedures for accounting for the effects of inflation are also described.

"Financial Record Book for Timber Growers," by Jeffrey C. Stier and Peter K. Dederich, is available from the Department of Forestry, University of Wisconsin-Madison, Madison, WI 53706. This looseleaf book demonstrates each of the accounts associated with timber investments and the applicable tax law. Blank forms are included.

Chapter X. Forest Records

Tax Purposes

Systematic and timely recording of forestry transactions by type, purpose and amount is extremely important for a long-term forestry investment. Accurate records coupled with a knowledge of the federal income tax rules allow you to ensure fair tax treatment on your income and expenses associated with a forest as intended by Congress. Tax features that may be of interest to you, as discussed earlier, include (1) qualifying timber revenues for long-term capital gains treatment; (2) recovering invested capital through depletion, depreciation, and amortization; and (3) deducting management expenses while complying with the passive activity loss rules. Installment sales may also be important.

As a general rule, you should keep accurate and complete documentation of your forestry activities to verify all entries made on tax returns. This includes invoices, contracts, receipts, canceled checks, and maps that validate woodland holdings and forestry operations. Such records should be preserved for a minimum of 3 years from the date a return is filed which is the ordinary limit for audit by the IRS. In some cases, this limit can stretch to 6 years after the return is filed and, if a return is false or fraudulent or if no return is filed, an action by the IRS can generally be brought at any time. The documents for land, timber, and other capital items, discussed in chapter V, should be held for the period of ownership plus a 3-year or longer period following disposition. Taxpayers should keep books and records adequate for audit (i.e., the books and records exist, are in proper form, and are readily accessible). An IRS auditor could compel you to produce the records needed to audit your return.

Management Information

Good records show the status of the timber inventory, timber growth rates, and cost and revenue information for your tree farm. This information can be used to analyze the efficiency of proposed management options enabling you to make informed choices in a timely manner. The records also serve as historical documents to help you avoid repeating mistakes.

Accounting Methods

You may adopt an accounting method that provides the most favorable tax treatment, as long as it "clearly reflects" income. It may be the same as one followed in other businesses or it may be different as dictated by the nature of your timber activities. The two accounting methods that are in general use are cash basis and accrual basis.

With the cash basis method, revenue is reported when actually or constructively received, and expenses are deducted when actually paid. Most small service firms and farms (including tree farms) have adopted cash basis accounting methods that are simple, flexible, and effective.

Under the accrual basis method, revenue is recorded when it is earned, whether or not you receive it at that time. Also, expenses are deducted when they are incurred rather than when you pay them. Accrual accounting is preferred by accountants and used by many incorporated tree farm businesses. It has the advantage of evenly matching income and expense, so that revenues and costs are recorded closer to the time they actually occur. Thus, the accrual basis reflects the economic activity that occurs, which may or may not be matched by a concurrent cash flow. One disadvantage of the accrual method is that it does not postpone the payment of tax until cash is actually received.

Taxpayers may use combinations of the cash and accrual methods as long as the method adequately reflects income and is followed consistently. IRS approval is generally necessary before accounting methods can be changed.

Recordkeeping Methods

Shoe Box

You should develop a systematic recordkeeping approach for your forest records, even for the small tree farm held as an investment. The much joked about shoe-box method is better than nothing at all if organized and followed routinely. If this method is adopted, a tree farmer could use business envelopes and label one for each tax category that applies to his or her situation. The categories that are important are discussed in previous chapters.

A Tree Farm Journal

To improve on the shoebox method, you should maintain a journal to record forest management information. A journal is a chronological business diary that contains the details of each business transaction—description, purpose, date, and dollar amounts involved (e.g., see fig. 10). In addition, you should include the time expended on an activity if you need such to establish the extent of your material participation for purposes of the passive loss rules as discussed on page 20. For tree farmers with limited management activities, such a journal may provide a sufficient record of transactions for tax purposes. However, you should sort entries by tax categories—capital transactions, deductions from gross income, or deductions from timber sale revenue.

A Tree Farm Journal With Accounts

As forestry operations increase in complexity, a journal becomes most useful as a diary of day-to-day tree farm activities that can be transferred (posted) systematically to appropriate accounts. Ledger accounts are established for

Figure 10—**Wilderness Tree Farm: Journal**

Date	Accounts and Explanation	Ref.	Debits	Credits
			$	$
06/01/80	Temporary capital account	1	2,500	
	Cash			2,500
	E.Z. Cruiser, Consultant for T.F. appraisal report			
06/01/80	Temporary capital account	2	188,180	
	Cash			88,180
	Mortgage payable			100,000
	R. Farmer, purchase Wilderness tree farm			
06/15/80	Temporary capital account	3	4,000	
	Cash			4,000
	S. Lawyer, attorney for title search, filing, and closing			
06/21/80	Land—Farmer tract (fig. 11)	5	62,073	
	Merchantable sawtimber (figs. 12, 15)	6a	91,557	
	Merchantable pulpwood (not shown)	7	16,635	
	Young growth (fig. 13)	8	12,415	
	Equipment (bridge, fig. 14)	9	12,000	
	Temporary capital account	4		194,680
	Allocation of tree farm purchase to permanent capital accounts			
12/31/80	Depreciation expense	10	700	
	Accumulated depreciation			700
	First year depreciation of bridge			
12/31/80	Interest expense	11	5,168	
	Mortgage payable		3,700	
	Cash			8,868
	Interest expense and mortgage principal reduction for 1980 (See Interest Expense and Mortgage Payable Accounts in table 7)			
01/15/81	Operating expense	12	421	
	Cash			421
	Forest suppliers for purchase of axes, posted signs, flagging			
06/01/81	Bridge maintenance	13	582	
	Truck maintenance		217	
	Road maintenance		897	
	Cash			1,696
	Forestry expenses for servicing truck, grading roads, pulling ditches, and repairing bridge			
12/31/81	Property tax expense	14	410	
	Cash			410
	Treasurer, local company			
02/15/82	Expenses of sale (table 7)	15	4,730	
	Cash			4,730
	E.Z. Cruiser, consultant for sale preparation (see also table 8)			
04/10/82	Cash	16	7,884	
	Timber sale revenue			7,884
	Deposit (10%), on timber sale from Sawyer Lumber Co.			
05/07/82	Cash	17	70,956	
	Timber sale revenue			70,956
	Balance of sale revenue from Sawyer Lumber Co. (see also table 7)			
12/31/82	Cost of timber sold[1]	18	54,934	
	Merchantable sawtimber Account (value)			54,934
	Allowable as basis for sale Merchantable sawtimber account (see also chapter XI)			
06/15/83	Reforestation account (not shown)	19	12,500	
	Cash			12,500
	B. Roller, contractor for site preparation on 60 acres of cutover			
08/26/83	Bridge maintenance	20	352	
	Road maintenance		578	
	Cash			930
	M. Truck, contractor for road grading, bridge repair			
09/01/83	Cash	21	5,000	
	Reforestation account (not shown)			5,000
	ASCS, receipt of FIP cost-share payments on site prep (see also table 8)			
12/31/83	Amortization of reforestation	22	509	
	Reforestation account (not shown)			509
	Amortization of site preparation (see table 10)			

[1] Volume removed in sale (see Form T) 438 MBF, is adjusted in Merchantable Sawtimber Account (Figure 12).

Figure 10—**Wilderness Tree Farm: Journal (Continued)**

Date	Accounts and Explanation	Ref.	Debits	Credits
			$	$
02/10/84	Reforestation account	23	3,600	
	Cash			3,600
	E.Z. Cruiser, contractor for planting pine on site prepared 60 acre cutover (see table 10)			
12/31/84	Amortization of reforestation	24	1,262	
	Reforestation account (not shown)			1,262
	Second year of site preparation and first year of planting amortization (see table 10)			
08/06/85	Timber stand improvement	25	1,500	
	Cash			1,500
	R. Axman, contractor for timber stand improvement in 60-acre natural pine stand			
09/01/85	Temporary capital account	26	97,000	
	Cash			97,000
	Mountain Realty Co., acquire Turkey Ridge—120 acres total			
09/02/85	Temporary capital account	27	6,400	
	Cash			6,400
	Mountain Realty Co., appraisal, title search, legal fees, etc. to acquire Turkey Ridge			
09/15/85	Total cost of property	28		103,400
	Land	29	31,979	
	Merchantable sawtimber (figs. 12 and 15)	30a	50,102	
	Young growth	31	6,396	
	Allocation of Turkey Ridge purchase to permanent capital accounts			
09/31/85	Pulpwood timber	32	12,415	
	Young growth			12,415
	Young growth transferred to pulpwood timber account (value not shown)			
11/01/86	Travel expense	33	276	
	Cash			276
	Routine inspection of boundaries, roads, and fire lines from the travel diary (not shown)			
12/31/86	Property tax expense	34	640	
	Cash			640
	To local county treasurer for property tax expenses			
12/31/86	Interest expense	35	4,538	
	Mortgage payable		10,663	
	Cash			15,201
	Interest expense and mortgage principal reduction for 1986			
12/31/86	Capital account	36	5,454	
	Travel expense			276
	Property tax expense			640
	Interest expense			4,538
	Election to capitalize carrying charges for 1986			
82/31/86	Capital account	37		5,454
	Merchantable sawtimber account		3,808	
	Pulpwood account (not shown)		1,349	
	Young growth account		297	
	Allocation of carrying charges to timber accounts			
12/31/86	Cash	38	600	
	Hunting lease			600
	Receipt of hunting lease payment from Laid Back Hunt Club			

each separate business or tax activity needed for the efficient operation of the business, and the timely reporting of financial and tax information.

The number and kind of ledger accounts will vary with the details of your forestry business. Accounts typically used include those that are specifically related to timber operations and those that are generally needed for any business. Only the basic accounts needed to illustrate tree farm records are introduced here. To save space, repetitive costs (e.g., annual property taxes) are not shown in the journal more than once. Forestry expenditures include accounts for both capital and expense items, as discussed in Chapter V. Revenues are placed in either capital gains or ordinary income accounts.

Capital accounts

Tree farm assets generally include (a) land, (b) timber and (c) other improvements. An account should be established for each item that adds significantly to the value of the property so that when these items are disposed of, wear out, or are used up they can be properly treated with respect to their contribution to the production of income.

The **land account** contains entries for the land and land improvements (fig. 11). Permanent land improvements include such things as nondepreciable roadbeds of roads that have indeterminate useful lives. The amounts for land and nondepreciable improvements can be combined in the basis account because they can be recovered for tax purposes as an offset against income only when the land is sold or otherwise disposed of.

Figure 11—**Wilderness Tree Farm: Land Account**

Date	Description of Activity	Ref.	Debits	Credits
			$	$
06/21/80	Allocation of Wilderness T.F. cost to land: Farmer Tract (see table 9)	5	62,073	
09/15/85	Allocation of Turkey Ridge purchase cost to land	29	31,979	
09/15/85	Adjusted balance (basis) carried forward		94,052	

A **timber account** may contain subaccounts for merchantable timber, non-merchantable young natural growth, and plantations. A merchantable timber account should include the merchantable volume that could have been harvested at prevailing utilization standards when the property was acquired (fig. 12). It should also include that portion of the original basis (see page 12) attributable to the initial merchantable volume.

Figure 12—**Wilderness Tree Farm. Merchantable Sawtimber Account—(Volume)***

Date	Description of Activity	Ref.	Additions	Removals
			MBF	
06/21/80	Estimated merchantable volume of pine and hardwood sawtimber at date of purchase (see Wilderness T.F. cruise in table 8)	6b	650	
01/02/82	Growth for 1980-82 (2 years: see cruise report, table 8)		80	
01/02/82	Adjusted volume carried forward		730	
12/31/82	Volume removed in sale	18b		438
12/31/82	Adjusted volume carried forward		292	
09/15/85	Estimated volume on Turkey Ridge when purchased (see table 8)	30b	750	
09/31/85	Adjusted volume carried forward		1,042	

*See figure 15 for corresponding value.

When **premerchantable timber** is acquired, its allocable portion of the acquisition cost on an acreage basis is established in a young-growth subaccount (fig. 13). The premerchantable timber basis is transferred to a merchantable account as the young growth reaches merchantability. An estimate of the volume per acre being transferred is also required. The transfer is made by increasing the basis and volume in the merchantable timber account while reducing the basis in the young growth account by a corresponding amount. In the example that follows, the basis of $12,415 and an estimated volume of 1,350 cords are transferred to a merchantable pulpwood account (not shown).

A **reforestation subaccount** (not shown) is similar to the premerchantable subaccount. It is created when a new stand is planted following a harvest. Replanting costs following a failure of the initial establishment effort must also be capitalized.

Amortization of Reforestation is an account for recording qualified reforestation amortization. An account must be established for each year that qualified expenditures are made (See chapter V, page 17 and table 7, item no. 17).

Depreciation accounts are established for equipment and other depreciable assets that are used on your tree farm (See fig. 14 and table 7, item no. 4). The cost of equipment used in forestry operations is established in subaccounts according to the procedures discussed in chapter V, page 12. Bridges, culverts, gravel surface on a road, and

Figure 13—**Wilderness Tree Farm: Young Growth Account**

Date	Description of Activity	Ref.	Debits	Credits
			$	$
06/21/80	Allocation of Wilderness T.F. purchase cost to young growth (60 acres of pine, see table 9)	8	12,415	
09/15/85	Allocation of Turkey Ridge purchase cost to young growth (40 acres, see table 9)	31	6,396	
09/31/85	Transfer young growth to Merchantable Pulpwood Account (value); volume estimated (cruised) to be 1,350 cords by E.Z. Cruiser	32		12,415
09/31/85	Adjusted balance carried forward		6,396	
12/31/86	Election to capitalize carrying costs proportional allocation	37	297	
12/31/86	Adjusted balance carried forward		6,693	

Figure 14—**Wilderness Tree Farm: Equipment Account**

Date	Description of Activity	Ref.	Debits	Credits
			$	$
06/21/80	Allocation of Wilderness T.F. purchase cost to equipment, a 90 foot wooden bridge (see table 9)	9	12,000	
12/31/80	Depreciation deduction for 1980 (straight line)	10		700
12/31/80	Adjusted balance carried forward		11,300	

(Subsequent depreciation entries are not shown).

fences are examples of depreciable land improvements for which subaccounts may also be established. They are depreciable because they wear out and have a determinable life.

Expense Accounts

The number of expense accounts you need depends on the nature of your operations. Property taxes, timber stand maintenance operations such as precommercial thinning, the costs of small tools and supplies, and equipment maintenance are some of the types of expenses that you may incur (e.g., see table 7). See also chapter V for a discussion of forestry expenses and their tax treatment, including the effect of the passive loss rules.

Capital Income Accounts

Timber normally generates capital gains or losses when you dispose of it. (See the discussion on capital gains in chapter VI). Accounts associated with timber dispositions include those for Timber Sale Revenue, Timber Sale Expenses, and Cost of Timber Sold (Basis) (table 7; accounts 14, no. 16, and no. 15, respectively).

Ordinary Income Accounts

Ordinary income may be generated in many ways from a tree farm. Examples are hunting lease payments, selling firewood from logging slash, and sale of wild nuts. Since ordinary income may be important for offsetting management expenses, appropriate accounts should be established to record it. **A Hunting Lease Account** illustrates this point (See table 7, ref. 38).

General Business Accounts

You also need to establish accounts basic to any business. A **Cash Account** is used to handle revenues, pay bills, and make allocations to other business accounts. Other categories of accounts for accumulating cash flows for business or tax decisions include **Interest Expense, Travel Expense, Vehicle Maintenance, Depreciation Expense, Accumulated Depreciation, Mortgage Payable, and Miscellaneous.** These are shown in table 7 in abbreviated form in order to provide continuity with the forestry accounts (fig. 11 through 15) in the following example of a tree farm purchase.

Table 7—Tree Farm Accounts

1. Cash Account

Ref.	Debits	Credits
	$	$
1		2,500
2		81,180
3		4,000
11		8,868
12		421
13		1,696
14		410
15		4,730
16	7,884	
17	70,956	
19		12,500
20		930
21	5,000	
23		3,600
25		1,500
26		97,000
27		6,400
33		276
34		640
35		15,201
38	600	

2. Temporary Capital Account

1	2,500	
2	188,180	
3	4,000	
4		194,680
26	97,000	
27	6,400	
28		103,400
36	5,454	
37		5,454

3. Mortgage Payable

Ref.	Debits	Credits
	$	$
2		100,000
11	3,700	
	Bal. fwd.	96,300
		*
	Bal. fwd.	55,231
35	10,663	
		*
	Bal. fwd.	44,568

*Repititious data omitted.

4. Depreciation Expense

10	700	

5. Accumulated Depreciation

10		700

6. Interest Expense

11	5,168	
		*
35	4,538	
36		4,538

*Repititious data omitted.

7. Travel Expense

33	276	
36		276

8. Operating Expenses

12	421	

9. Truck Maintenance

13.	217	

10. Bridge Maintenance

13	582	
20	352	

11. Road Maintenance

Ref.	Debits	Credits
	$	$
13	897	
20	578	

12. Property Tax Expense

14	410	
34	640	
36		640

13. Timber Stand Improvement

25	1,500	

14. Timber Sale Revenue

16		7,884
17		70,956
	Bal. fwd.	78,840

15. Cost of Timber Sold (Basis)

18	54,934	

16. Expenses of Sale

15	4,730	

17. Amortization of Reforestation

22	509	
24	1,262	

18. Hunting Lease

38		600

Example 20

Records for a Tree Farm Purchase: Wilderness Tree Farm was purchased by R. Farmer from B. Smith on June 1, 1980. Farmer subsequently purchased the adjoining Turkey Ridge tract on September 2, 1985, from Mountain Realty Company. The transactions to acquire these properties, allocate the purchase price to the respective capital accounts, pay annual operating expenses, sell timber and reforest the harvested stands are recorded in the Tree Farm Journal (fig. 10). They are then transferred (posted) to the respective capital accounts (fig. 11 through 15) and to the general business accounts that are shown in abbreviated form in table 7.

The transactions are briefly explained to illustrate the process of handling various cash flows and the tax treatment these should receive.The consulting forester's appraisal for the Wilderness property is shown in table 8. The appraisal cost of $2,500 (fig. 10, ref. 1) and the legal fees for $4,000 (fig. 10, ref. 3) are capital acquisition costs for purchasing the property. They are added to the $188,180 purchase price (ref. 2) of the property that was allocated to the capital accounts. The initial bookkeeping is handled with a temporary capital account that reflects the $194,680 total cost of the acquisition (ref. 4). Allocation of the acquisition cost to the capital accounts is shown in table 9. The basis in land is recorded in the Land Account (fig. 11, ref. 5). Similarly, the basis in merchantable timber is recorded in the Merchantable Sawtimber Account (fig. 15, ref. 6a) and to Merchantable Pulpwood (ref. 7, but not shown). A corresponding estimate of the merchantable volume—650 MBF—is reported in the Merchantable Sawtimber Account (fig. 12, ref. 6b). The young growth is recorded in the Young Growth Account (fig. 13, ref. 8). The basis of the bridge is posted to the Equipment Account (fig. 14, ref. 9). It is depreciated using a straight line method with a 10-year life and an assumed salvage value of zero. The first year depreciation deduction is shown in table 7 (no. 4, ref. 10) and the depreciation is accumulated in Account No. 5 (ref. 10).

The business loan on Wilderness Tree Farm is amortized, and interest expense, which is deductible (fig. 10 ref. 11), and reduction of principal, which is not deductible (table 7, account 3), are recorded in separate accounts.

Various operating expenses for the Wilderness Tree Farm that are also shown in table 7 include supplies (ref. 12), maintenance (ref. 13), and property taxes (ref. 14). See chapter V for a discussion of expenses.

When Farmer planned to sell timber in 1982 he hired a consulting forester to prepare the sale for a fee of $4,730 (ref. 15). The bid deposit and balance of the sale income are recorded in Account 14, Timber Sale Revenue (table 7, refs. 16 and 17, respectively). The cost of timber sold (allowable basis) is calculated using information from the Merchantable Sawtimber Account (fig. 12 and 15). This amount of $54,934 (ref. 18) is recorded in Account 15, Cost of Timber Sold (table 7).

The harvested 60 acres is site prepared for reforestation (fig. 10, ref. 19). Farmer received FIP cost-share payments of $5,000 (ref. 21). The amortization schedule is shown in Table 10. First year amortization deduction is shown in table 7, Account 17, Amortization of Reforestation (ref. 22). The expenditures for reforestation are recorded in the Reforestation Account (not shown). The site prepared tract was planted the following year for $3,600, for which no cost-share payment was received (fig. 10, ref. 23). The amortization is shown in table 7 account 17.

Farmer spent $1,500 on timber stand operations in order to maintain the quality and growth of selected trees. This is a deductible expense shown in table 7, Account 13, ref. 25.

In 1985 the adjoining tract was purchased by Farmer. The purchase and allocation of capital is similar to the establishment of the original accounts. These additions show the adjustments to basis in the Land Account (fig. 11, ref. 29), Merchantable Timber (fig. 12 ref. 30b, and fig. 15, ref. 30) and Young Growth (fig. 13, ref. 31).

When the young growth in the original purchase reached merchantability in 1985, it was transferred from the Young Growth Account (fig. 13, ref. 32) to the Merchantable Pulpwood Account (not shown).

In 1986 Farmer's fortunes were not good, resulting in zero taxable income. He elected to capitalize as carrying charges the expenses for travel (fig. 10, ref. 33), property taxes (ref. 34) and interest (ref. 35). The total of $5,454 is proportionally allocated to the timber accounts (fig. 10, ref. 37).

The diversity of Wilderness Tree Farm—mixtures of timber species, various age classes, and openings caused by harvesting—offered good hunting prospects. Farmer leased the property for 5 years to the Laid Back Hunt Club for $600 per year ($2 per acre per year). Most members are neighbors, and the agreement included a clause for protection from trespass and fire. The first payment was received at the end of 1986 (table 7, ref. 18 and fig. 10, ref. 38).

Blank forms for beginning a Tree Farm Journal and Accounts for Merchantable Timber, Young Growth, and Reforestation are shown in appendix III. These are the minimum needed for efficiently recording information in tree farm capital accounts. Other general business accounts such as those suggested in table 7 should be added as needed to reflect the complexity of the tree farm operations.

Figure 15—**Wilderness Tree Farm: Merchantable Sawtimber Account (Value)**

Date	Description of Activity	Ref.	Debits	Credits
			$	$
06/21/80	Allocation of Wilderness T.F. purchase cost to timber	6a	91,557	
12/31/82	Allowable as basis for sale	18a		54,934
12/31/82	Adjusted basis carried forward		36,623	
09/15/85	Allocation of Turkey Ridge purchase to timber (see table 8)	30a	50,102	
09/15/85	Adjusted basis carried forward		86,725	
12/31/85	Election to capitalize carrying charges	37	3,808	
12/31/85	Adjusted basis carried forward		90,533	

Table 8—**Summary of Cruise Reports for Wilderness Tree Farm and Turkey Ridge Tree Farm Purchases**

Description of Assets	Value
Wilderness Tree Farm (01/15/80):	
1. 200 acres of average site land @ $300/acre =	$ 60,000
2. Merchantable pine and mixed hardwood sawtimber on 100 acres,[1] Pine—400 MBF @ $165/MBF = $66,000 Hardwood—250 MBF @ $90/MBF = $22,500	88,500
3. Pulpwood—pine and mixed hardwood on 40 acres[1] Pine—880 cords @ $15/cord = $13,200 Hardwood—320 cords @ $9/cord = $2,880	16,080
4. Young growth pine averaging 8 years old on 60 acres 60 acres @ $200/acre =	12,000
5. Used wooden bridge—90 feet (10-year expected life with no salvage value	11,600
Total asset value:	**$188,180**
Turkey Ridge Tree Farm (08/01/85):	
1. 120 acres of fair quality land @ $250/acre =	30,000
2. Merchantable pine—hardwood sawtimber on 80 acres[1] Pine—470 MBF @ $100/MBF = $47,000 Hardwood—280 MBF @ $50/MBF = $14,000	61,000
3. Young growth pine averaging 5 years old on 40 acres 40 acres @ $150/acre =	6,000
Total asset value:	**$97,000**

Submitted by: E.Z. Cruiser, Registered Forester No. 424.

[1] Growth rate averages 6 percent in these stands.

Table 9—**Allocation of Wilderness Tree Farm Assets to Capital Accounts**

Account	Fair market value (FMV)	Percent of total FMV	Allocation of acquisition cost	Original cost
	$	%	$	$
Land	60,000	31.88	2,073	62,073
Sawtimber	88,500	47.03	3,057	91,557
Pulpwood	16,080	8.55	555	16,635
Young growth	12,000	6.38	415	12,415
Bridge	11,600	6.16	400	12,000
Total	188,180	100.00	6,500	194,680

Table 10—**Reforestation Tax Credit and Amortization Schedules**

For 1983 Federal tax returns:	
Site preparation cost (see ref. 19)	$12,500
Less FIP cost-share payment (See ref. 21) (Payment excluded from gross income)	5,000
Total out-of-pocket cost eligible for credit and amortization	$7,500
Investment credit (Report on IRS Form 3468):	
$7,500 × 10% =	$750
Amortization schedule (Report on IRS Form 4562):	
(1) Reduce amortizable basis by one half of credit claimed: $7,500 – ($750 × .5) =	$7,125
(2) Compute deductions over 7 years (8 tax years) using one-half year convention (i.e. only 6 months is claimed in first and last years)	
1983 and 1990 returns; (See ref. 22) $7,125 × (1/14) =	$509
1984 - 1989 returns; (See ref. 24) $7,125 × (1/7) =	$1,018
For 1984 Federal tax returns:	
Planting cost (See ref. 23)	$3,600
Total out-of-pocket reforestation cost eligible for credit and amortization (i.e., cost-share was not received on this activity)	$3,600
Investment credit:	
$3,600 × 10% =	$360
Amortization schedule:	
(1) Reduce basis for credit taken: $3,600 – ($360 × .5) =	$3,420
(2) Amortization deductions:	
1984 and 1991 returns, (See ref. 24) $3,420 × (1/14) =	$244
1985 – 1990 returns, $3,420 × (1/7) =	$489

Glossary

Amortization. The process by which the basis of certain capital assets, such as qualifying reforestation expenditures, is recovered. The rate of recovery is based on a set time period.

Accounts. A record of all transactions that affect one segment of a business. Examples are a cash account, land account, merchantable timber account, and depreciation account.

Basis. In general, the amount paid for property, including expenditures made in connection with the purchase, is the basis of the property. The basis of property acquired by other means is determined by the manner of acquisition (for determining the basis of property acquired by inheritance or gift, see page 11).

Adjusted.—The original basis less any reductions made because of depreciation, depletion, amortization, or losses claimed, plus any additions made by capitalization of improvements, carrying charges, or additions to the asset.

Allowable.—The portion of the adjusted basis that can be offset against the revenue received when standing timber is sold or otherwise disposed of.

Stepped-up.—Assets acquired by inheritance take as their basis the fair market value of the asset on the deceased's date of death or on the alternate valuation date. This value is generally greater than the basis of the asset in the hands of the deceased. The basis is therefore stepped-up (increased) in passing from the deceased to the person inheriting it.

Benefit Cost Ratio. The discounted present value of all revenues from an investment divided by the discounted value of all costs. It is usually expressed as a ratio such as 1.10 to 1.0 if the benefits were 10 percent greater than costs.

Board Foot (bd. ft.). The standard of measure for certain trees, logs, and other products cut therefrom. The unit is one foot square and one inch thick. Tables based on various "log rules" are used to convert tree and log lengths and diameters into board foot volumes.

Business. Generally, an activity carried out for the realization of a profit and characterized by regular transactions. Neither the Code nor Regulations provide a precise definition of the term "trade or business."

Capital Account. An account used to keep track of the basis and quantity of such assets as land, timber, buildings, and equipment.

Capital Gain or Loss. Generally, the gain or loss realized on the sale or exchange of capital assets such as land, timber, buildings, and equipment. Income received in this manner is treated differently for tax purposes than income received in the form of wages or salary, or the profit realized from the operation of a business.

Capitalize. The process of adding the amount paid for property and additional qualifying expenditures to a capital account. The capitalized amount is recoverable through depreciation, depletion, amortization, or sale or exchange of property.

Carrying Charge. Expenditures made to carry an asset, that is, maintain possession. Examples are interest, taxes, and insurance.

Casualty. An identifiable event of a sudden, unexpected, and unusual nature. The complete or partial loss (destruction) of property resulting from a casualty is known as a casualty loss.

Code. Refers to the Internal Revenue Code of 1986, as amended. This is the written tax law as enacted by the U.S. Congress. The Department of the Treasury issues regulations to interpret the Code. Revenue rulings published by the IRS provide information and guidance in applying the tax law and regulations correctly and uniformly.

Conversion Cost. The cost of converting standing timber into a salable product, such as logs, lumber, and railroad ties. In the case of producing lumber, the costs include those incurred to cut down (fell) the trees, cut off the limbs, section the tree stem into logs (buck), move the logs to a point where they can be loaded on a truck (skid), transport the logs to a sawmill and saw the logs into lumber.

Cord. A unit of measure used in conjunction with timber to be converted into pulpwood, firewood, or other products that are not produced or measured in terms of board feet. A standard cord is a 4 × 4 × 8 foot stack of wood.

Cruise. The process by which the volume, type, and quality of timber within a designated area is determined. The cruise can be made by actually measuring the dimensions of each tree, referred to as a timber inventory. A cruise can also be made by measuring only those trees selected in a statistically based sampling scheme. If the timber within the designated area is uniform, the total volume within the area can be estimated to a predetermined level of accuracy by measuring the trees on a portion of the total area.

Depletion. The using up or wasting away of a natural resource. In the case of timber, it is the recovery of the owner's basis in timber, referred to as "depletion allowance". The term applies when timber is cut by the owner and the logs cut from the timber are sold or used in the owner's business.

Average.—If all of the timber from more than one tract and of various grades and species is included in one timber account, the depletion unit, and therefore the depletion allowance or allowable basis, is an average of all the timber in the account.

Species or Value.—Under certain conditions it may be permissible to maintain separate timber depletion accounts for individual species, value, or product classes of timber from one or more tracts.

Depreciation. The process by which the basis of assets, such as equipment, buildings, and fences, is recovered as the assets are used for the production of income.

Disposal. Timber is disposed of when the owner cuts, sells, or exchanges timber, or otherwise parts with the property. In the case of a 631(b) transaction, timber is disposed of when the owner transfers cutting rights to another under a binding contract obligating the seller to sell and the purchaser to cut at the time cutting begins.

Economic Interest. This concept was developed by the U.S. Supreme Court to determine which taxpayers in addition to the fee owner of property qualify for certain tax benefits. Section 631(b), discussed on page ____, requires that an economic interest be retained. An economic interest is retained in every case in which the taxpayer has acquired by investment any interest in standing timber and secures, by any form of legal relationship, income derived from the severance of the timber to which the taxpayer must look for a return of capital.

Equal Annual Equivalent. This is the net annual return (or cost) over the life of an investment for a given discount rate. It is similar to an installment payment over the life of a loan.

Executory Contract. A contract that specifies the agreement reached between the contracting parties, but that does not become effective unless and until some specified event or action has occurred. A timber sale contract may, for example, specify that the timber is not sold under the contract until the buyer has cut the timber and determined the volume cut.

Expensing. Recovery of expenses by deducting them in full in the year they are paid or incurred.

Fair Market Value. The price at which property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all the necessary facts.

Farm. Generally, a trade or business producing "farm income." Specific sections of the Code more precisely define farming for purposes of that particular section. Many Code sections specifically exclude the production of timber from the definition of farming.

Felled Timber. Timber in trees that have been cut down (severed) and are lying on the ground.

Forester.

Consulting.—Foresters for hire on a contract basis. They charge a daily fee plus expenses for certain types of services and provide other services on a fixed cost contract basis. Some charge a fixed percentage of the sale price to provide all or a portion of the services required in connection with timber sales.

Extension.—Foresters employed by the Cooperative Extension Service of the State. They are usually based at the State's land-grant university. Their primary function is to provide educational materials and related services. In some States they are available for a limited amount of on-the-ground assistance to individual landowners.

Industry.—Foresters employed by a timber growing and/or processing company. They frequently provide technical assistance in conjunction with timber purchased from private landowners. Many companies also have formal programs through which they make their foresters available to assist landowners in all aspects of timber management.

Service.—Also referred to as "District" or "State" foresters, they are employed by the state agency charged with responsibility for protecting the state's public and private forest lands. These foresters are available for a wide variety of services, although the amount of time they can devote to any one landowner is generally limited. They also approve and certify financial assistance to landowners under the Forestry Incentives and Agricultural Conservation Programs. Their services are usually free.

Girdling. The process of encircling the trunk of a tree with a cut that stops the flow of nutrients between leaves and roots, resulting in the death of the tree.

Hobby. An activity engaged in without the primary intent of realizing a profit.

Income

Active.—Income generated by a trade or business activity in which the taxpayer materially participates.

Capital.—See capital gain.

Farm.—Income received from the sale of agricultural commodities such as grain, livestock, fruit, vegetables, dairy products, poultry, and fish.

Ordinary.—Income received in the form of wages, salary, rent, etc.

Passive.—Income generated by a trade or business activity in which the taxpayer does not materially participate.

Portfolio.—Income generated by certain investment activities.

Investment. An activity engaged in with the intention of realizing a profit, but not rising to the level of a trade or business.

Involuntary Exchange. The exchange of an asset, for money or other property, when the exchange results from a cause beyond the control of the owner, such as a casualty, theft, or condemnation.

Journal. A record of business transactions recorded in chronological order. It usually shows the date, amount of transaction, description including names, and the accounts affected.

Ledger. A book of accounts.

Lessee. The person to whom the lease is made, for example, the timber company in the case of a timberland owner who leases land to a timber company.

Lessor. The person granting the lease, for example, a timberland owner who leases to a timber company the right to cut and grow timber on the land.

Log Rule. A measuring formula that gives the relationship between the diameter and length of a log and the board foot volume of lumber which could be sawn from the log. It is assumed that the entire log is sawn into one-inch thick boards. Several rules have been developed based on varying assumptions about the thickness of the saw and sawing practice used. Some of the standard rules are International 1/4 inch, Scribner decimal C, and Doyle.

Marking. The process of designating the trees that are to be sold and cut. A common practice is to spray indelible paint on the tree at eye level and at ground level. This allows the buyer to identify the trees to be sold and the seller to determine that only marked trees were cut.

Material Participation. The act of participating in the operations of a trade or business activity on a regular, continuous, and substantial basis.

Net Present Value. The discounted present value of all revenues and all costs associated with an investment.

Proceeds. The total amount received from the disposition of an asset, either as payment in cash, notes or other securities, services in kind, or any other valuable consideration.

Regulations. The interpretations by the Department of the Treasury of the Federal tax laws (Code) enacted by the U.S. Congress. They provide the official rules for applying the Code to the circumstances of specific taxpayers.

Revenue Rulings. The official interpretations by the Internal Revenue Service of the application of the Code, related statutes, tax treaties, and Regulations to specific circumstances. They are published for the information and guidance of taxpayers, IRS personnel, and others concerned.

Scaling. The process of measuring the dimensions of individual logs or trees. The measurements are used to estimate the volume of the logs or trees by applying the dimensions to a log rule or tree volume table.

Severance Tax. A state excise tax levied on the cutting of timber. In most States in which the tax is levied, it is in addition to any property taxes levied or taxes in lieu of property taxes. Funds generated are often designated for specific forestry related purposes such as fire control, reforestation, and public forestry assistance.

Site Preparation. The preparation of land for the planting of tree seedlings or tree seeding. The objectives include reduction of brush and other obstacles to allow planting equipment to operate, reduction of vegetation that would compete with young trees, scarification of the soil to provide a suitable seedbed, and other action that may be required to alter the site to accommodate new trees.

Stumpage. Standing timber or, more generally, recoverable wood in those trees that have not been severed from their roots by cutting. Stumpage would therefore include the wood in trees that have been blown over or broken by wind or ice storms.

Sublessor. A lessee who leases a leasehold interest to a third party.

Timber.

Defined.—For federal income tax purposes, timber generally means the wood in standing trees that is available and suitable for exploitation and use by the forest industries. Section 631 of the Code broadens the meaning to include certain evergreen trees cut and sold for ornamental purposes, see page 41.

Tresspass.—An unlawful taking of timber without the permission of the owner.

Time Line. A diagram showing the year when costs are incurred and income is received over the period of a timber investment.

Transaction. An accounting term used to designate an action or event that leads to an entry in the books of account.

Yield Tax. A State tax due when income is realized from harvesting timber. It is usually levied in lieu of an ad valorem tax that would otherwise be due on the timber itself.

Appendix I—Summaries of Selected Revenue Rulings

Pertinent revenue rulings (Rev. Rul.) dealing with timber are summarized below. Obsolete and inconsequential rulings have been omitted. Citations are given to the complete texts: Cumulative Bulletin (C.B.) published by the U.S. Department of the Treasury. The rulings are categorized by general subject and listed alphabetically within each general subject by key word.

Basis and Depletion Allowance

Cutting contract, advanced royalties—Advanced royalties paid or accrued by a lessee under a timber cutting contract in a tax year for timber cut during that year are not deductible under the provisions of reg. 1.612–3(b)(3), but are to be added to the lessee's depletable basis in the timber. Treas. Reg. §§1.612-3, 1.631–2. (Secs. 612, 631), Rev. Rul. 77–400, 1977–2 C.B. 206.

Christmas trees, capital and operating expenditures—In connection with the cultivation, as a trade or business, of Christmas trees for purposes of sale when they are more than 6 years old, the expenditures incurred for planting, must be capitalized. Expenditures incurred for silvicultural practices such as weeding, cleaning, and noncommercial thinning are deductible as ordinary and necessary trade or business expenses. The cost of land improvements is capitalized in the land account. The cost of purchased equipment and other depreciable assets, such as culverts and fences, should be capitalized and recovered through the allowance for depreciation. Rev. Rul. 66–18,. 1966–1 C.B. 59.

Christmas trees, capital and operating expenditures—Costs incurred for shearing and basal pruning of trees grown for the Christmas tree market are deductible business expenses. (Sec. 62). Rev. Rul. 66–18 modified. Rev. Rul. 71–228, 1971–1 C.B. 53.

Long-term contracts, royalties vs. rent—The fair market value of the timber existing at the time of the execution of a long-term timber purchase contract constitutes the basis for depletion of the timber and payments in excess of the fair market value are consideration for the use of land deductible as a business expense. Amplified by Rev. Rul. 78-267. Treas. Reg. §§1.162–1, 1.612–1. (Secs. 162, 612). Rev. Rul. 75–59, 1975–1 C.B. 177.

"Purchaser credit" road construction contract, Forest Service—The basis for cost depletion of timber does not include the "purchaser credit" earned for specified road construction under a Forest Service contract. Further, amounts expended for construction of such roads are recovered through depreciation if the roads are used for harvesting the timber or added to the depletion basis if the roads are not used for harvesting the timber. Treas. Reg. §§1.611–5, 1.612–1, 1.631–1. (Secs. 611, 612, 631). Rev. Rul. 71–354, 1971–2 C.B. 246.

Reforestation, replacing dead seedlings—A timber producer sustains no deductible loss on the death, not due to casualty, of tree seedlings planted to reforest land from which it has harvested the mature timber. Amounts paid or incurred in replanting to replace the lost seedlings must be capitalized in accordance with reg. 1.611–3(a). Treas. Reg. §§1.165–1, 1.611–3. (Secs. 165, 611). Rev. Rul. 81–2, 1981–1 C.B. 78.

Reforestation—Generally, direct costs of reforestation including girdling, herbicide application, baiting of rodents, labor and tool expense, and the planting and seeding equipment depreciation are capital expenditures recoverable through depletion allowances when the timber is cut or as adjusted basis if the timber is sold. Indirect costs, deducted in the year incurred or capitalized cumulatively under section 266, include interest paid on money borrowed or service charges on performance bonds in lieu thereof to satisfy a State law requiring a deposit to guarantee reforestation. Rev. Rul. 55–252 superseded. Treas. Reg. §§1.263(a)–1, 1.611–1, 1.1011–1 (Secs. 263, 611, 1011). Rev. Rul. 75–467, 1975–2 C.B. 93.

Reforestation, payments under forestry incentives program—The excludable portion of cost-sharing payments received under the forestry incentives program (F.I.P.) is excludable from gross income, and the total costs of reforestation less the excludable portion are to be capitalized as a cost of timber. Under the election not to have section 126 apply to the F.I.P. payment, the entire payment is includible in gross income, and the total costs of reforestation (not reduced by any portion of the F.I.P. payment) are to be capitalized as a cost of timber. Rev. Rul. 76–6 modified and superseded. Treas. Reg. §§1.61–1, 16A.126–1, 16A.126–2, 1.194–1, 1.611–3. (Secs. 61, 126, 194, 611). Rev. Rul. 84–67, 1984–1 C.B. 28.

Reforestation expenditures—The expenditures for destroying undesirable hardwood trees and brush in naturally reforested stands of southern pine young growth when related primarily to the seeding and establishment of the pine seedlings are capital expenditures recoverable through depletion. Treas. Reg. §§1.611–3. (Sec. 611). Rev. Rul. 76–290, 1976–2 C.B. 188.

Capital Gains

Cutting contract, "contract right to cut" defined—To be entitled to the benefits of section 631(a) of the Code as the holder of a "contract right to cut" timber, a taxpayer must have acquired under such contract a proprietary interest in the timber which he cuts. Treas. Reg. §§1.631–1 (Sec. 631). Rev. Rul. 58–295, 1958–1 C.B. 249.

Cutting contract, contract right to cut, future right—An option on a right to cut timber that is transferred as part of an exchange of property is not an enforceable contract right to cut for section 631(a) purposes, in cases where the claimed right to cut is exercisable only after a future date or occurrence or is contingent upon an election or a transfer of additional consideration by a taxpayer. The holding period in such cases commences only when the right to cut becomes exercisable. Treas. Reg. §§1.631-1 (Sec. 631). Rev. Rul. 74-529, 1974-2 C.B. 151.

Contract cutting, road credit—The amount subject to treatment under section 631(b) by a corporate timberland owner that disposes of timber under a cutting contract that specifies the unit price for an estimated number of units and the amount of a "road credit" allowed the purchaser for building access roads is the actual amount realized, which is the total contract price reduced by the road credit. Treas. Reg. §§1.631-2. (Sec. 631). Rev. Rul. 75-306, 1975-2 C.B. 243.

Christmas trees sold on "choose and cut" basis—Income realized from the sale of Christmas trees that are selected and cut on the taxpayer's land by individual purchasers is ordinary income. However, the taxpayer may elect to treat the cutting of trees as sales or exchanges of timber as prescribed by reg. 1.631-1. Treas. Reg. §§1.631-1, 1.1231-1. (Secs. 631, 1231). Rev. Rul. 77-229, 1977-2 C.B. 210.

Cutting contract, fair market value of timber cut—The terms of a contract under which the taxpayer acquired the unrestricted right to cut and use timber in its lumber manufacturing business are not relevant in determining the fair market value of timber cut. Treas. Reg. §§1.631-1. (Sec. 631). Rev. Rul. 74-271, 1974-1 C.B. 151.

Cutting contract, payment for failure to cut—Amounts received under a timber cutting contract for timber cut, the quantity of which is based upon a "cruise" rather than scaling, qualifies for treatment under section 631(b). A penalty payment received for failure to cut any portion of the "cruised" or marked trees during the term of the contract is ordinary income. Treas. Reg. §§1.631-2. (Sec.631). Rev. Rul. 78-104, 1978-1 C.B. 194.

Cutting contract, quantity first determined, holding period—A taxpayer who acquired timber cutting rights under a USDA Forest Service cutting contract is considered to have first definitely determined the quantity of timber cut, for the purposes of the election to treat cutting of timber as a sale or exchange, when a truck scale was made using a bureau scaler at the time the logs arrived at the taxpayer's sawmill even though a mill deck scale was made later by a Forest Service scaler. Distinguished by Rev. Rul. 73-489. Treas. Reg. §§1.631-1. (Sec. 631). Rev. Rul. 73-267, 1973-1 C.B. 306.

Cutting contract, quantity first determined, holding period—A fiscal-year accrual method taxpayer who acquired timber cutting rights under USDA Forest Service cutting contracts requiring that, for payment purposes, logs be scaled by a Forest Service scaler and who elects to treat the cutting of timber as a sale or exchange is considered to have cut the timber for purposes of section 631(a) when the logs are scaled on the mill deck by the Forest Service scaler in the ordinary course of business. Rev. Rul. 73-489, 1973-2 C.B. 208.

Default of performance bond—An amount received by the fee-owner of certain timber lands from the default of a cash performance bond posted by a grantee under a contract involving the cutting and disposal of timber is not an amount realized from the disposal of timber and is taxable as ordinary income. Treas. Reg. §§1.631-1. (Sec. 631). Rev. Rul 61-56, 1961-1 C.B. 243.

Disposal, expenses for—Expenditures directly attributable to a disposal of timber are reductions of the amount received for purposes of computing gain or loss from such disposal. Whether expenditures are directly attributable to a disposal is determined on the strength or persuasiveness of each case and how closely related to the disposal the activities are in connection with the expenditures. Treas. Reg. §§1.631-2. (Sec. 631). Rev. Rul. 71-334, 1971-2 C.B. 248.

Disposal, economic interest retained—In the case of the disposal of timber, held for the requisite period of time prior to disposal, by the owner thereof under any type of contract by virtue of which the owner retains an economic interest in such timber, the amount received qualifies for capital gain treatment regardless of the nature of the taxpayer's business or the purpose for which the timber is held. (Sec. 631, 1231). Rev. Rul. 57-90, 1957-1 C.C. 199.

Holding period—A taxpayer who acquired timber on December 31, 1962, and still owned it at the beginning of his tax year which began July 1, 1963, has owned such timber for a period of more than 6 months before the beginning of such tax year for purposes of Section 631(a). Treas. Reg. §1.631-1. (Sec. 631). Rev. Rul. 66-6, 1966-1 C.B. 160.

Holding period—A capital asset acquired on the last day of any calendar month, regardless of whether the month has 31 days, must not be disposed of until on or after the first day of the seventh succeeding month of the calendar in order to have been "held for more than 6 months," within the meaning of sections 1222(3) and (4), and 1231. Rev. Rul. 66-7, 1966-1 C.B. 188.

LIFO inventory valuation reserve—A taxpayer who elects to treat the cutting of timber as a sale or exchange and who adopts the LIFO inventory method may use, in financial statements to shareholders and for credit purposes, an inventory reserve reflecting the difference between the fair market value of the timber cut and the adjusted cost basis of such timber, determined without reference to such fair market value. Treas. Reg. §§1.472-2, 1.631-1. (Secs. 472, 631). Rev. Rul. 60-244, 1960-2 C.B. 167.

Long-term contract, capital gains vs. ordinary income—Under a contract for a term of 60 years granting the right to grow timber and to cut timber growing and to be grown, a paper company was obligated to make yearly payments not contingent on the quantities of timber cut. Held, the transaction is not a "disposal" of timber under section 631(b).

Payments equal to the fair market value of the timber existing at the execution of the contract are proceeds of a sale of timber and any gain included in this amount is capital gains, provided the conditions of sections 1221 or 1231 are met. Any excess of such payments over the fair market value of the timber existing at the execution of the contract is ordinary income. Amplified by Rev. Rul. 78-267. Treas. Reg. §§1.631-2. 1.1221-1, 1.1231-1. (Secs. 631, 1221, 1231). Rev. Rul. 62-81, 1962-1 C.B. 153.

Long-term contract, unstated interest—The application of the unstated interest provisions to long-term timber contracts is described in situations in which the taxpayer is (1) a landowner who receives the entire consideration under the contract in a lump sum on the date the contract is signed, (2) a landowner who is to receive payments over a period of 60 years under a contract for the sale of timber and lease of the land on which the timber is growing, and (3) a paper company that makes payments under a contract similar to that in situation 2. Rev. Ruls. 62-81, 62-82 and 75-59 amplified. Treas. Reg. §§1.483-1, 1.1221-1, 1.1231-1. (Secs. 483, 1221, 1231). Rev. Rul. 78-267, 1978-2 C.B. 171.

Long-term lease, lump sum payment—A lump sum payment received under a contract for the lease of land and the grant of the right to cut timber therefrom constitutes proceeds of the sale of timber to the extent of the fair market value of the timber then existing. The resulting gain or loss is subject to the treatment described in sections 1221 or 1231 provided the conditions thereof are met. Any excess of such payments over the fair market value of the existing timber is ordinary income. Amplified by Rev. Rul. 78-267. Treas. Reg. §§1.631-1, 1.1221-1, 1.1231-1. (Secs. 631, 1221, 1231). Rev. Rul. 62-82, 1962-1 C.B. 155.

Pulpwood from tops and limbs of sawtimber trees—Treating the cutting of timber as the disposal of standing trees for capital gain purposes applies only to the disposal of standing trees and not to the sale of tree tops and limbs lying on the ground. Income from the sale of the tree tops and limbs is ordinary gain or loss; however, the section 631(a) benefits apply to the entire standing tree. The method of computing the fair market value of such trees is determined. (Sec. 631). Rev. Rul. 56-434, 1956-2 C.B. 334.

Right to cut and remove for landowner—A taxpayer who acquires by contract the right to cut, remove and sell timber from the land of another for the account of the landowner, but not the right to cut the timber for sale on his own account or for use in his trade or business, is not the holder of "a contract right to cut" for purposes of the election under Section 631(a). Also, the taxpayer is not entitled to the treatment provided by section 631(b), relating to a disposal by the owner. Treas. Reg. §§1.631-1. (Sec. 631). Rev. Rul. 58-579, 1958-2 C.B. 361.

Timberland, sale of, used in trade or business—Gain realized by an electing small business corporation from the sale of timberland held primarily for the production of timber products and not for sale to customers is gain from the sale of real property used in a trade or business under Section 1231(b) of the Code, subject to the provisions of Section 1.1375-1(d) of the regulations. Treas. Reg. §§1.231-1, 1.1375-1. (Secs. 1231, 1375.) Rev. Rul. 73-222, 1973-1 C.B. 373.

When "cut"—For purposes of determining capital gain or loss, timber is considered "cut" at the time when in the ordinary course of business the quantity of timber felled is first definitely determined, rather than at the time of the felling. Treas. Reg. §§1.631-1. (Sec. 631). Rev. Rul. 58-135, 1958-1 C.B. 519.

Timberland tracts, deeds in escrow, holding period—The holding period of each of several tracts in a timber acreage purchased under a single indivisible contract with annual payments and release of deeds from escrow based on tracts selected for cutting begins on the day after the execution of the contract. Treas. Reg. §§1.631-1. (Sec. 631). Rev. Rul. 72-252, 1972-1 C.B. 193.

Tree stumps, investment property—Income from the sale of tree stumps by a timberland owner who is not in the business of buying or selling timber is taxable as a capital gain where the land was acquired in a cutover state as a real estate investment and the stumps were sold in one lot. (Sec. 1221). Rev. Rul. 57-9, 1957-1 C.B. 265.

Involuntary Conversions

Casualty loss, deduction limited to basis—The allowable deduction for a casualty loss due to destruction of timber by hurricane may not exceed the adjusted basis for determining loss from the sale or other disposition of the quantity of timber which by fair and reasonable estimates is found to be unfit for use because of the hurricane. Distinguished by Rev. Rul. 87-59. Treas. Reg. §§1.165-7 (Sec. 165). Rev. Rul. 66-9, 1966-1 C.B. 39.

Casualty loss, insect—The death of ornamental trees 5 to 10 days following a massive southern pine beetle attack in an area not known for such massive attacks results in an allowable casualty loss deduction to the extent provided by Section 165(c). Modifies Rev. Rul. 57-599. Distinguished by Rev. Rul. 87-59. Treas. Reg. §§1.165-7 (Sec. 165). Rev. Rul. 79-174, 1979-1 C.B. 99.

Casualty loss, partial damage—Ice storm damage to merchantable trees that reduces the rate of growth or quality of subsequent timber increment but does not render the existing timber unfit for use is not a deductible casualty loss. Treas. Reg. §§1.165-7 (Sec. 165.) Rev. Rul. 73-51, 1973-1 C.B. 75.

Casualty loss, nonrecognition of gain—The nonrecognition of gain provisions of Section 1033(a) are applicable to the proceeds received from the voluntary sale of timber downed by high winds, earthquake, or a volcanic eruption when the proceeds are used to purchase other standing timber. Rev.

Rul. 72–372 revoked. Treas. Reg. §§1.1033(a)–2 (Sec. 1033). Rev. Rul. 80–175, 1980–2 C.B. 230.

Losses, timber in trees killed by insects—Loss of timber over a 9-month period following an unexpected and unusual insect attack that killed the timber trees gives rise to an allowable noncasualty business loss deduction that must be netted with other noncasualty Section 1231 gains and losses. Rev. Ruls. 66–9 and 79–174 distinguished. Treas. Reg. §§1.165–1, 1.165–7, 1.611–3, 1.1231–1. (Secs. 165, 611, 1231). Rev. Rul. 87–59, 1987–2 C.B. 59.

Appendix II—Form T (Timber)

Form **T** (Timber) (Rev. January 1987) Department of the Treasury Internal Revenue Service	**Forest Industries Schedules** ► **Attach to your tax return.**	OMB No. 1545-0007 Expires 10-31-89
Check form of organization: ☐ Corporation ☐ Partnership ☐ Fiduciary ☐ Individual	Name Address (number and street) City or town, state, and ZIP code	**Taxpayer identifying number** For tax year ended

GENERAL INSTRUCTIONS

(Section references are to the Internal Revenue Code, unless otherwise noted.)

Paperwork Reduction Act Notice

We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Who must complete Form T.—If you claim a deduction for depletion of timber or for depreciation of plant and other improvements related to timber accounts, or elect to claim gain or loss as provided by section 631(a) for cutting timber, you must complete and attach Form T to your income tax return. Generally, Form T should be filed when a taxpayer sells or cuts standing timber or is involved with other timber transactions.

Complete this form in accordance with sections 611, 631, and 1231 and related regulations. If you need more space, attach separate sheets and number each answer so that we can identify it with the appropriate item on Form T.

Items You Should Note

The Tax Reform Act of 1986 (Act) generally repealed the capital gain deduction for tax years beginning after 1986. However, certain transitional rules apply. For more information, see the instructions for the income tax return to which Form T is attached and **Publication 544**, Sales and Other Dispositions of Assets.

Change to Revocation Procedure

The Act allows taxpayers that made an election under section 631(a) before 1987 to revoke the election without the consent of the Secretary. In addition, the revocation will not affect any future election under section 631(a) and any future revocation will require the consent of the Secretary.

Schedule A Maps

1. This schedule consists of a map (or maps) of your timber properties. Whether you file the maps with your income tax return is your option, but you must make them available on examination of your return. Maps of convenient size are desirable, varying in scale from approximately 4 inches to the mile in small tracts to 1/2 inch to the mile in tracts larger than 200,000 acres. The maps should show your name and the tax year covered. Give standard map symbols in enough detail to show clearly the location of: (a) timber cutting contracts acquired separately from the land, (b) forest lands acquired, (c) areas where you cut timber, (d) timber cutting contracts sold or otherwise disposed of, (e) forest land sold or otherwise disposed of, and (f) forest land sold or otherwise disposed of with the timber cutting rights reserved to you or outstanding in third parties.

Schedule B Purchases

2. For the tax year, report acquisitions (such as purchases or exchanges, whether taxable or not) of timber, timber cutting contracts, or forest land. Report separately each single purchase totaling $10,000 or more, giving month and year of purchase. You may combine purchases of less than $10,000 for each timber or land account, and omit item 5 for combined small purchases. For a purchase or lease of timber cutting rights on a pay-as-cut basis, do not answer items 6 through 10. Instead, give briefly the provisions of the purchase or lease agreement, including the number of years from effective date to date of expiration, minimum cut or payment, and the payment rates for the different kinds of timber and forest products involved. You may report totals for small purchases on a pay-as-cut basis completed within the tax year. Follow the format of items 3 through 10 on additional sheets if you need more space.

3. Name of block and title of account

4. Location of property (by legal subdivisions, or map surveys)

5. a Seller's name and address	**b** Date of purchase
6. Amount paid: **a** in cash	
b in interest-bearing notes	
c in noninterest-bearing notes	
7. a Amount paid in other considerations	
b Explanation of the nature of other considerations and how the value given in 7a was determined ►	▨
8. a Legal expense	
b Cruising, surveying, and other acquisition expenses	
9. Total cost of property (Add lines 6a through 8b)	

Schedule B Purchases *(Continued)*

10. Allocation of total cost on books:	Unit or kind	Number of units	Cost per unit	Total cost
a Forested land	Acre			
b Other unimproved land	Acre			
c Improved land (Describe) ▶	Acre			
d Timber (Estimated total quantity of timber present on the acquisition date. (See section 1.611-3(e) of the regulations.) Details of the timber estimate, made for purposes of the acquisition, should be available on examination of your return.)				
e Premerchantable timber. (Make an allocation here only if it is a factor in the total cost or value of the land.)				
f Improvements (List separately)				
g Mineral rights				
h Total cost (same as line 9)				

Schedule C Profit or Loss From Land and Timber Sales

11. For the tax year, report all dispositions (such as by sale or exchange, whether taxable or tax free) of timber, timber cutting contracts, or forest land. Report separately each single sale involving a total consideration of $10,000 or more. You may combine sales of less than $10,000 for each timber or land account. You may omit item 14 for such combined small sales. For a sale or lease of timber cutting rights on a pay-as-cut basis, to be paid for at intervals during the cutting period according to the number of units cut, answer items 15, 19, and 20 for the tax year only. Instead of answering items 16, 17, and 18, give briefly the provisions of the sale or lease agreement, including the number of years from effective date to date of expiration, minimum cut or payment, and the payment rates for the different kinds of timber and forest products involved. You may combine small sales on a pay-as-cut basis completed within the tax year. Follow the format of items 12 through 20 on additional sheets if you need more space.

12. Name of block and title of account

13. Location of property (by legal subdivisions or map surveys)

14. a Purchaser's name and address

b Date of sale

15. Amount received: a in cash	
b in interest-bearing notes	
c in noninterest-bearing notes	
16. Amount received in other considerations	
17. Explanation of the nature of other considerations and how you determined the value given on line 16 ▶	▨
18. Total amount received for property (Add lines 15 and 16)	

Schedule C Profit or Loss From Land and Timber Sales *(Continued)*

19. Adjusted basis (cost) in property on sale or exchange date:	Unit or kind	Number of units	Cost per unit	Total cost
a Forested land	Acre			
b Nonforested land	Acre			
c Improved land (Describe) ▶	Acre			
d Merchantable timber. (Estimated total quantity of merchantable timber present on sale or exchange date. Give a detailed estimate as made for sale or exchange purposes. Include the quantity of each species of timber by diameter (DBH) classes. Name the log rule or other units of measure used.)				
e Premerchantable timber				
f Improvements (List separately)				
g Mineral rights				
h Total adjusted basis				
i Direct sale expenses (cruising, marking, selling)				
20. Profit or loss (line 18 less the total of lines 19h and 19i)				

Schedule D Losses

21. If you had losses during the tax year from fire, insects, wind, or other causes, and if you claimed the loss on your income tax return, show separately the proof of loss for each timber account and complete items 22 through 25.

22. Cause of loss

23. Location and area of land on which loss took place

24. a Total loss before any insurance recovery
b Less amount received from insurance
c Loss as claimed on tax return

25. Explain in detail how total loss (line 24) was determined

Schedule E Reforestation and Timber Stand Improvement

26. This schedule summarizes your expenses for reforestation and timber stand improvement during the tax year. You should keep on file the detailed information necessary to support the costs reported in this schedule and make it available on examination of your return. The total in Schedule E includes such things as supplies, labor, overhead, transportation, tools, and depreciation on equipment.

Site Preparation.—Report all expenses incurred during the tax year for preparation of the land for planting or seeding (including natural seeding). Include expenses for clearing the land of brush and cull trees by burning, disking, chopping, KG blading, spraying with herbicides, or other measures taken to aid in the successful reforestation of the site. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

Planting or Seeding.—Report your expenses incurred during the tax year for planting seedlings or sowing seed to reforest the land. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work. You must make detailed records available to the examining agent upon request, including separate costs for hand planting and machine planting or any other explanation of the kind of expenditures.

Precommercial Thinning or Fertilization.—Report all expenditures that are required to be capitalized and items that you elect to capitalize. Also, list on a separate attachment those items that are currently deductible. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

Schedule E Reforestation and Timber Stand Improvement *(Continued)*

Account, block, tract, or area	Kind of activity (burning, chopping, spraying, planting, seeding, thinning, pruning, fertilizing, etc.)	Number of acres treated	Total expenditures
Total			

Schedule F Capital Returnable Through Depletion

In items 27 through 42, give separately the data for each timber account, covering any changes that have taken place during the tax year. Attach as many additional pages of this form as you need. If you deplete on the block basis, combine new purchases with the opening balances and use the average depletion rate shown on item 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in board feet or other log scale name the log rule used.

	Quantity in board feet, log scale, or other unit [1] (1)	Cost or other basis (2)
27. Title of account (name of block or tract) ▶ ____________		
28. Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year		
29. Increase or decrease of quantity of timber required by way of correction[2]		▨
30. a Addition for growth (Period covered ▶ ________ years)		▨
b Transfers from premerchantable timber account		
c Transfers from deferred reforestation account		
31. Timber acquired during year		
32. Addition to capital during year[3]	▨	
33. Total at end of year, before depletion (add lines 28 through 32, in each column)		
34. Unit rate returnable through depletion, or basis of sales or losses (line 33, column 2, divided by line 33, column 1)	▨	
35. Quantity of timber cut during year		▨
36. Depletion sustained (line 34 multiplied by line 35)	▨	
37. Quantity of timber sold or otherwise disposed of during year		▨
38. Allowable as basis of sale (line 34 multiplied by line 37)	▨	
39. Quantity of timber lost by fire or other cause during year		▨
40. Allowable basis of loss (line 34 multiplied by line 39)	▨	
41. Total reductions during year:	▨	▨
a Add line 35, column 1; line 37, column 1; and line 39, column 1		▨
b Add line 36, column 2; line 38, column 2; and line 40, column 2	▨	
42. Net quantity and value at end of year (line 33, column 1 less line 41a, column 1; and line 33, column 2 less line 41b, column 2)		

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[1] If M board feet log scale is not the unit used, state what unit you used and explain it.

[2] Adjust the quantity in M feet, log scale, or other unit remaining at the end of the year for changes in reinventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, state clearly the basis for it.

[3] Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions in the return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

43. Quantity of timber cut that was sold as logs or other rough products ____________

44. Did you elect in your income tax return to report gain or loss from the cutting of timber in accordance with section 631(a) of the Internal Revenue Code? ☐ **Yes** ☐ **No**

If "Yes," furnish the information asked for in items 45 through 51.

45. Gain or loss as reported in your return. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis.

46. Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.

If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown in item 34, after adjustment.

Schedule F Capital Returnable Through Depletion *(Continued)*

47. Section 631(a)—Election to consider cutting as a sale or exchange:

- To make the section 631(a) election for timber acquired before June 23, 1984, and after December 31, 1987, you must have owned or have held a contract right to cut the timber for a period of more than one year prior to cutting.
- To make the section 631(a) election for timber acquired after June 22, 1984, and before January 1, 1988, you must have owned or have held a contract right to cut the timber on the first day of the tax year and for a period of more than 6 months prior to cutting.

If you make the election, you are required to determine the fair market value of the timber cut during the year as of the beginning of the tax year. The value required is the value of the timber as it stood in the forest on the first day of the tax year. Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, distance to markets, and the like.

48. Give evidence in the form of actual sales of comparable timber as of the valuation date, along with other value evidence used. Include a computation showing the difference between the cost (excluding timber or stumpage cost) and value of the primary wood product (logs or other roundwood, chips, etc.) at the mill or plant. Give detailed evidence that permits a comparison with the timber on which you report a value.

49. For all purchases and sales of timber you make, and for all other transactions you report, furnish the relevant information called for by items 2 through 20.

50. Furnish the following additional information:

(a) The log transportation system used, such as truck roads, railroads, etc., and the main topographic features of the area cut over during the year, as they affect logging and transportation conditions. You may show this in accompanying maps.

(b) The location of the sawmill, log market, or other point of delivery of the logs or wood to the user or buyer.

(c) The total log scale or other units of timber cut, and the length and diameter of the average log or the average number of units per tree.

(d) The percentage of rough lumber grades, by species, produced from the timber manufactured during the year or, if the timber is sold in the log, the percentage of log grades, by species.

51. Section 631(a) applies only to timber owned, or held under a contract right to cut for the periods specified in item 47 depending on when the timber was acquired. In your records show the quantity of timber cut that you held for the required period. Show separately the quantity of timber cut that was not so held. Also, the scale of logs purchased during the year must be shown by species and quantity and excluded from the quantity shown as cut under section 631(a). Records must also show the number, cost, and point of delivery of purchased logs by species and grade.

Schedule G Land Ownership

52. Show changes in land accounts as carried on your books. Attach as many additional sheets as you need, following the format of items 53 through 58.

53. Name of account ►	Acres	Total cost or value. Give amount of March 1, 1913, appreciation, if included	Average rate per acre
54. Balance at beginning of year			
55. Purchases during year			
56. Sales during year			
57. Other changes			
58. Balance at end of year (Add lines 54 and 55, less lines 56 and 57)			

Optional Schedules

59. If the supporting statements for Schedules H and I are too numerous to file with your return, you must retain this information and make it available on examination of your return. Include separate cost accounts for construction by you and by the contractor.

Schedule H Road Construction Cost

60. Report under items 61 and 62 the expenditures incurred for road construction during the tax year. Report separately for each depletion account, block, tract, or geographic area tributary to a mill or mill complex.

61. Roads constructed on lands owned in fee:

a Miles constructed

b Amount capitalized to nondepreciable account

c Amount placed in depreciation account

d Amount claimed as an ordinary expense

e Total amount spent (Add lines 61b, c, and d)

f Amount reported as investment credit property

62. Roads constructed for logging timber held under leases or cutting contracts having a term of 2 years or longer:

a Miles constructed

b Amount to be amortized

c Amount claimed as an ordinary expense

d Total amount spent (Add lines 62b and c)

e Amount reported as investment credit property

Schedule I Drainage Structures

63. Report expenses incurred during the tax year for construction of water level control devices such as ditches and canals. List each kind of structure separately for each depletion account, block, tract, or geographic area tributary to a mill or mill complex:

a	Kind of structure ▶	▨
b	Miles constructed	
c	Purpose of structure ▶	▨
d	Amount capitalized to nondepreciable account	
e	Amount placed in depreciable or amortizable account	
f	Amount reported as an ordinary expense	
g	Total amount spent (Add lines 63d, e, and f)	

Appendix III—Forms for Recording Your Timber Transactions

The following accounting forms can be used to record your timber transactions. You can use only the journal forms to record transactions as they occur or you can transfer all transactions to ledger forms as shown in chapter X. You can write in your own ledger account names on the blank pages using the list of accounts in chapter X as a guide. Due to the relatively small number of transactions for some accounts you may want to put more than one account on a page. You can get an indication of the amount of space to leave for each account from the accounts in table 7 of chapter X.

Because of the new passive loss rules it is important for many noncorporate timberland owners to record the time they spend on their timber activity. Journal entries to record the date, purpose of trip, mileage, and hours spent on different tree farm activities will help to ensure that these items are not forgotten. These entries will also help to document hourly requirements to qualify for material participation purposes under the passive loss rules.

Business Journal ____________________

Date	Description: Account numbers, quantities, and hours spent (for passive loss rules).	Reference	Debits ($)		Credits ($)	

Business Journal ______________________________

Date	Description: Account numbers, quantities, and hours spent (for passive loss rules).	Reference	Debits ($)		Credits ($)	

Date		Reference	Debits $		Credits $	

Date		Reference	Debits $		Credits $	

Date		Reference	Debits $		Credits $	

Date		Reference	Debits $		Credits $	

Date		Reference	Debits $		Credits $	

Date		Reference	Debits $		Credits $	

Date		Reference	Debits $		Credits $	

Date		Reference	Debits $		Credits $	

Date		Reference	Debits $		Credits $	

Date		Reference	Debits $	Credits $

Land Account ______________________________

Date	Description: Deed # ______________, permanent improvement, etc.	Reference	Debits $		Credits $	

Land Account ______________________________

Date	Description: Deed # ____________, permanent improvement, etc.	Reference	Debits $		Credits $	

Merchantable Timber Account ($ basis, volume) ______________________

Date	Description (basis): Purchases, transfers, capitalization, and disposals.	Reference	Debits $		Credits $	
	Merchantable timber (volume): Cords, MBF, etc.		Additions, units		Removals, units	

best copy available

Merchantable Timber Account ($ basis, volume) ______________________________

Date	Description (basis): Purchases, transfers, capitalization, and disposals.	Reference	Debits $		Credits $	
	Merchantable timber (volume): Cords, MBF, etc.		Additions, units		Removals, units	

Young Growth Account ($ basis, acres) ____________________

Date	Description: Purchases, disposals, acreage, and stand age.	Reference	Debits $		Credits $	
	Young growth account (volume acres): Cords, MBF, etc.		Additions, units		Removals, units	

Young Growth Account ($ basis, acres) ______________________________

Date	Description: Purchases, disposals, acreage, and stand age.	Reference	Debits $		Credits $	
	Young growth account (volume acres): Cords, MBF, etc.		Additions, units		Removals, units	

Equipment Account

Date	Description: Type, make, model, and year	Reference	Debits $		Credits $	

Equipment Account ____

Date	Description: Type, make, model, and year	Reference	Debits $		Credits $	

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